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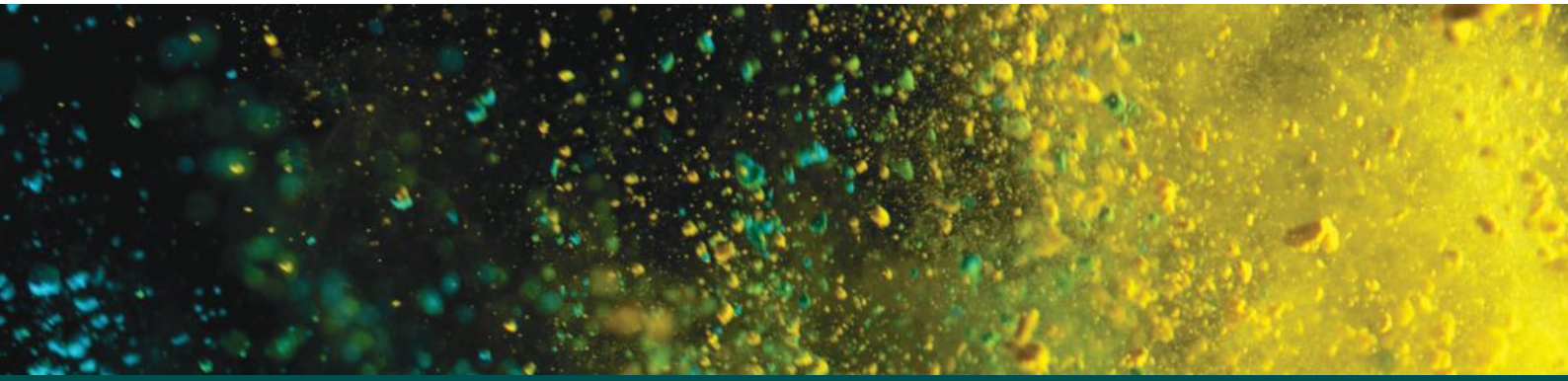

TRADE AND DEVELOPMENT REPORT 2020

FROM GLOBAL PANDEMIC TO PROSPERITY FOR ALL: AVOIDING ANOTHER LOST DECADE

UNITED NATIONS

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UNITED NATIONS CONFERENCE ON TRADE AND DEVELOPMENT

TRADE AND DEVELOPMENT REPORT 2020

FROM GLOBAL PANDEMIC TO PROSPERITY FOR ALL: AVOIDING ANOTHER LOST DECADE

Report by the secretariat of the
United Nations Conference on Trade and Development

UNITED NATIONS
Geneva, 2020

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Foreword

Covid-19 has served as a reminder that we live in a closely interdependent world that brings opportunities but also carries dangers. It has, just as importantly, shed light on a whole series of pre-existing conditions – from heightened inequality, to unsustainable debt and rampant environmental destruction – that were left unaddressed after the Global Financial Crisis. The world at the end of 2019 was, in truth, a good deal more fragile than many were willing to acknowledge. As a result, Covid-19 obliges us to think carefully about what makes for healthy and resilient communities, at the global level as much as the local level and take to heart the lessons we have learned in the last decade.

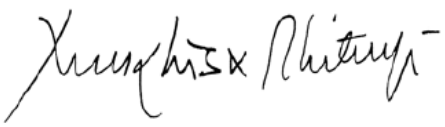
This year is shaping up to be a very difficult year for the global economy. With many countries unprepared to respond to a health pandemic, lockdown seemed to be the only plausible way to protect lives and preserve health systems. Doing so triggered an economic crisis that spread as quickly as the virus itself. Data for the first two quarters of this year show output contracted more sharply than in 2008-2009, and in some cases registering the steepest drop on record. Estimates for the year point to a generalized global recession matching the Great Depression of the 1930s.

Next year will likely see a rebound. However, it will be uneven within and across countries and uncertainty will persist. Unemployment will be on an upward trend, more and more companies will be facing the threat of bankruptcy; supply chains will be fragile; confidence will be shaken; demand will be weak. Debt levels across the world, in both the public and private sectors, will have risen significantly from the historically high levels registered before the crisis. In this condition, the wrong policy steps – and ignoring the experience of the last decade – could trigger further shocks which would not only derail recovery but could usher in a lost decade.

These threats are greatest in the developing countries where the ability to respond to the crisis, on both the health and economic fronts, has been hampered by years of austerity combined with massive debt servicing, high levels of informality and policy space constricted by the rules we've chosen to manage globalisation. To date, the international community has not matched its expression of concern with commensurate support and action. Multilateralism was already under stress before the crisis, but Covid-19 has highlighted the need for frank discussion and bold proposals that match the ambition shown when the global system was founded.

This year's *Trade and Development Report* argues that the global economic crisis caused by Covid-19 throws up a stark choice: continue misguided policy choices or collectively chart a new path that leads from recovery to a more resilient, more equal and more environmentally sustainable world in line with the ambition of the 2030 Agenda for Sustainable Development.

Neither path is preordained. Building a better world is a matter of conviction and collective action. The lives of future generations and of the planet itself will depend on the choices we all take over the coming months.



Mukhisa Kituyi
Secretary-General of UNCTAD

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Explanatory notes

Classification by country or commodity group

The classification of countries in this *Report* has been adopted solely for the purposes of statistical or analytical convenience and does not necessarily imply any judgement concerning the stage of development of a particular country or area.

There is no established convention for the designation of "developing", "transition" and "developed" countries or areas in the United Nations system. This *Report* follows the classification as defined in the *UNCTAD Handbook of Statistics 2019* (United Nations publication, Sales No. E.20.II.D.1) for these three major country groupings (see https://unctad.org/en/PublicationsLibrary/tdstat44_en.pdf).

For statistical purposes, regional groupings and classifications by commodity group used in this *Report* follow generally those employed in the *UNCTAD Handbook of Statistics 2019* unless otherwise stated. The data for China do not include those for Hong Kong Special Administrative Region (Hong Kong SAR), Macao Special Administrative Region (Macao SAR) and Taiwan Province of China.

The terms "country" / "economy" refer, as appropriate, also to territories or areas.

References to "Latin America" in the text or tables include the Caribbean countries unless otherwise indicated.

References to "sub-Saharan Africa" in the text or tables include South Africa unless otherwise indicated.

Other notes

References in the text to *TDR* are to the *Trade and Development Report* (of a particular year). For example, *TDR 2019* refers to *Trade and Development Report 2019* (United Nations publication, Sales No. E.19.II.D.15).

References in the text to the United States are to the United States of America and those to the United Kingdom are to the United Kingdom of Great Britain and Northern Ireland.

The term "dollar" ($) refers to United States dollars, unless otherwise stated.

The term "billion" signifies 1,000 million.

The term "trillion" signifies 1,000,000 million.

The term "tons" refers to metric tons.

Annual rates of growth and change refer to compound rates.

Exports are valued FOB and imports CIF, unless otherwise specified.

Use of a dash (–) between dates representing years, e.g. 2018–2020, signifies the full period involved, including the initial and final years.

An oblique stroke (/) between two years, e.g. 2018/19, signifies a fiscal or crop year.

A dot (.) in a table indicates that the item is not applicable.

Two dots (..) in a table indicate that the data are not available, or are not separately reported.

A dash (–) or a zero (0) in a table indicates that the amount is nil or negligible.

Decimals and percentages do not necessarily add up to totals because of rounding.

Abbreviations

BEPS	Base Erosion and Profit Shifting
BIS	Bank of International Settlements
BRICS	Brazil, Russian Federation, India, China and South Africa
CCRT	Catastrophe Containment and Relief Trust.
CDOs	Collateralized Debt Obligations
CIS	Commonwealth of Independent States
CLOs	Collateralized Loan Obligations
CPB	Netherlands Bureau for Economic Policy Analysis
CRAs	credit rating agencies
DSSI	Debt Service Suspension Initiative
ECB	European Central Bank
ECLAC	Economic Commission for Latin America and the Caribbean
EITI	Extractive Industries Transparency Initiative
EIU	Economist Intelligence Unit
EU	European Union
FDI	foreign direct investment
FIRE	finance, insurance and real estate
FYP	Five-Year Plan
G20	Group of Twenty
GDP	gross domestic product
GFC	global financial crisis
GPM	Global Policy Model
GST	goods and services taxes
GVC	global value chains
HIPC	Heavily Indebted Poor Countries
IATA	Air Transport Association
ICTs	information and communications technologies
IFF	illicit financial flows
IIF	The Institute of International Finance
ILO	International Labour Organisation
IMF	International Monetary Fund
IPCC	Intergovernmental Panel on Climate Change
ISDS	investor-state dispute settlement
ISM	United States Institute for Supply Management
KFW	Kreditanstalt für Wiederaufbau
MDRI	Multilateral Debt Relief Initiative
MERS	Middle East Respiratory Syndrome
MICs	middle-income developing countries
MNEs	multinational enterprises
MSCI	Morgan Stanley MSCI indices for equities
NAFTA	North American Free Trade Agreement
NBS	China National Bureau of Statistics
NEXGEM	JP Morgan Next Generation Markets Index
NPC	National People's Congress
ODA	official development assistance
OECD	Organisation for Economic Co-operation and Development
OPEC+	Organization of the Petroleum Exporting Countries Plus
PMI	Purchasing Managers' Index
PPPs	public-private partnerships

PRGT	Poverty Reduction and Growth Trust
QE	quantitative easing
SARS	Severe Acute Respiratory Syndrome
SCDIs	state-contingent debt instruments
SDG	Sustainable Development Goals
SDRMs	sovereign debt restructuring mechanisms
SDRs	special drawing rights
SMEs	small and medium enterprises
TRIMS	Trade Related Investment Measures
TRIPS	Trade Related Intellectual Property Measures
UNDESA	United Nations Department of Economic and Social Affairs
UNIDO	United Nations Industrial Development Organization
UNSD	United Nations Statistics Division
UNWTO	United Nations World Tourism Organization
VAT	value-added taxes
WB	World Bank
WESP	World Economic Situation and Prospects
WGP	world gross product
WHO	World Health Organisation
WIOD	World Input-Output Database
WTI	West Texas Intermediate
WTO	World Trade Organisation

OVERVIEW

The future is not what it used to be

The world economy is experiencing a deep recession amid a still-unchecked pandemic. Now is the time to hammer out a plan for global recovery, one that can credibly return even the most vulnerable countries to a stronger position than they were before. *The status quo ante*, is a goal not worth the name. And the task is urgent, for right now, history is repeating itself, this time with a disturbing mix of both tragedy and farce.

Ten years ago, the world's major economies vowed to bounce back from the worst financial crisis since the Great Depression and struck a tone that suggested a readiness to recast the international order in a manner inspired by the people who led the march out of war and ruin after 1945. In April 2009, leaders of the G20 gathered in London to agree a collective response to the global financial crisis that had ambushed leaders from Tokyo to Washington and Beijing to Buenos Aires.

The plan agreed in London was bold: restore confidence, growth, and jobs; repair the financial system to restart lending; strengthen financial regulation to rebuild trust; fund and reform international financial institutions to help overcome this crisis and prevent future ones; promote global trade and investment and reject protectionism; and forge an inclusive, environmentally sustainable recovery.

But it didn't happen. Or, rather, it was honoured more in the breach than the observance: trillions of dollars were spent on repairing the financial system but with little contrition on the part of bankers for past misdeeds or accountability, either in the form of prosecutions or serious reform; new free trade agreements took shape but with no acknowledgement that previous agreements had contributed to a more unequal and fragile world; Europe and the United States turned toward "structural reforms" and austerity on the false premise that too much regulation and a bloated public sector would restrain future growth. The result was a self-reinforcing cycle of weak aggregate demand, tepid growth and widening inequality.

Now another crisis, in the form of a microscopic pathogen that rapidly made its way around the world, is throwing into sharp relief the shortcomings of the global economy and its stewardship. In March this year, with Covid-19 contagion becoming a full-blown pandemic and the death toll rising, governments across the world opted for a policy-induced economic coma – stopping the human interactions that define much of commercial life – to prevent new infections and relieve overburdened health systems. This Great Lockdown, as the IMF calls it, has tipped the global economy into recession in 2020 on a scale not witnessed since the 1930s. Massive relief packages have been adopted, particularly by advanced economies, and the medical community has come together in search of a vaccine. Still uncertainty abounds and anxiety persists. Additional waves of infection and death cannot be ruled out.

The overall employment impact this year from the combination of lockdown, temporary relief and return to work is difficult to gauge. Still, the ILO estimates that more than 500 million jobs worldwide have been put in jeopardy by the crisis mainly in the developing world, and while many jobs will return with the end of workplace closures, some will be permanently lost; at least 100 million jobs will have gone entirely by year

end. Furthermore, between 90 million and 120 million people will be pushed into extreme poverty in the developing world, with hunger and malnutrition certain to follow, while income gaps will widen everywhere. These developments point toward a massive uptick in sickness and death.

Hope of a rapid economic bounce-back from a scientific breakthrough – in the form of an effective and widely available vaccine – cannot blind us to other man-made dangers ahead. If governments opt for premature fiscal tightening in an attempt to bring down public debt and businesses adopt an aggressive cost-cutting strategy in an attempt to boost exports, the recovery will likely fizzle out, with a double-dip recession a real possibility in many countries in 2022.

The threat is of particular concern for developing countries where a combination of precarious work conditions, high levels of debt distress and insufficient fiscal and policy space limit their options to respond to shocks of any kind, let alone one as serious as Covid-19. The urgent need for increased health spending along with declining tax revenues, combined with a collapse in export earnings and pending debt payments has exposed a $2-3 trillion financing gap in the developing world which the international community has, so far, failed to address. There is a very serious danger that the shortfall will drag developing countries into another lost decade ending any hope of realizing the ambition of the 2030 Agenda for Sustainable Development. The inability of the international community to agree on comprehensive debt standstills and write-downs, the resistance to rapid provision of appropriate levels of emergency liquidity and the reluctance to rein in rogue bondholders in sovereign debt negotiations along with the sight of vulture capital already hovering ominously over distressed economies are early warning signs that things could get worse – far worse.

In the absence of a radical policy shift and effective coordination at the international level, there will be pressure to return to the pre-crisis normal as quickly as possible, in a manner reminiscent of the period after the 2008 financial crisis. The call to "reglobalise" on free market principles is already being voiced, on the assumption that only renewed trade and capital flows will put the global economy on the path to recovery and resilient growth. Ardent free marketeers are using the disruption in international supply chains to push new rules on international trade and investment, and new privileges for owners of intellectual property and vital technologies that would further reduce the policy space of developing countries. Demands for a retrenchment in government spending are sure to follow. But adherence to those principles is precisely why a resilient recovery failed to emerge after 2010, indeed, why trade and foreign direct investment flows were anemic before the pandemic hit.

An aborted economic recovery, or worse, another lost decade, is not preordained. It is a matter of policy choice. An inclusive recovery will require a willingness on the part of government not only to keep spending for as long as it takes the private sector to regain its confidence to spend, but also to tackle the underlying stresses and fractures that were already exposed by the global financial crisis, papered over, and left to fester for a decade. It means addressing a series of pre-existing conditions that were threatening the health of the global economy before the pandemic hit, including high and entrenched inequality, sluggish growth, weak investment, endemic wage repression in the developed world and precarious working conditions in the developing world. Deficient welfare and care systems, and deepening environmental stress, not least because of the world's failure to delink economic activity from greenhouse gas emissions, remain high barriers to an equitable recovery.

The coronavirus has ruptured this world and, as with past global pandemics, raised fundamental questions about the way we organise society and the values that structure our lives. But it has also encouraged us to imagine a better world. If we are to act on that imagination, we should acknowledge the mistakes of the last decade, above all in the world's richest economies. Recovering better demands that we treat the Covid-19 pandemic not only as a crisis to be managed, but an opportunity to identify and address the structural barriers in the way of a more prosperous, equitable and resilient future. Success will turn less on epidemiology than it will on leaders at the national and international levels, and their willingness to confront the human consequences of their decisions. The measure of our success cannot be whether we ward off another financial crisis and avoid increased public debt. Succeeding generations will not applaud higher share prices or fuller treasuries if we fail to meet the challenge – and sacrifice an untold number of lives and livelihoods in the process.

Look back in anger

The recovery from the global financial crisis was sluggish by historical standards and unbalanced between households (with those at the very top grabbing a disproportionately large share of the increased income), firms (with large corporations raising their share of profits often at the expense of smaller business) and regions (with large metropolitan areas pulling further ahead). Policy did not leave people behind so much as it picked who wins and who loses.

Monetary policy, more by default than design, took the lead in orchestrating recovery, and rising equity and other asset prices were taken as a measure of success and a distraction from lagging wage growth and growing inequality. Government spending did increase, but the programmes targeted large firms and financial institutions, not workers, homeowners and local communities. And once tax breaks, bailouts and cheap money had helped calm market nerves, calls for fiscal rectitude grew ever louder; a swift turn to austerity combined with "structural reforms" – often little more than a euphemism for weakening social safety nets and keeping wages in check – extinguished hopes of a demand-led growth strategy that would lead to a sustainable medium- to longer-term recovery of jobs and incomes.

While the withdrawal of fiscal stimulus adversely impacted growth, the continuation of quantitative easing and low interest rates propelled asset prices ever higher. At the same time, a combination of corporate rent-seeking and cheap credit, in the context of weak demand, reinforced a culture of quick financial returns, with private equity, outsourcing, share buy-backs and mergers and acquisitions the instruments of choice; to take a startling example, between 2010–2019, S&P 500 companies channelled almost a trillion dollars a year in to share buy backs and dividend payments.

With central banks in advanced economies sticking to an easy money policy, tighter financial conditions in developing countries opened up new investment opportunities for those with access to liquid resources and an appetite for risk. This global search for a return on invested capital has led to a rapid build-up of foreign currency denominated public and private debt in many developing countries, along with increased penetration of their financial markets by non-resident investors, foreign banks, and other more shadowy financial institutions. The greater presence of foreigners in bond and equity markets, moreover, increased the potential instability of exchange rates and further exposed domestic financial markets to the vagaries of global risk appetite and liquidity conditions.

The coexistence of bubbles of financial exuberance with inadequate demand for goods and non-financial services, weak investment and lagging productivity constrained growth everywhere. In advanced economies, the average growth rate between 2010–2019 fluctuated around an annual average of 2 per cent, compared with 2.4 per cent from 2001–2007. Growth declined for developing countries from 7.9 per cent in 2010 to 3.5 per cent in 2019, with an annual average of just 5.0 per cent compared with 6.9 per cent from 2001–2007 (or 3.4 and 4.9 respectively, excluding China).

Putting a cost on the great financial crisis is a difficult business; one estimate by the Federal Reserve Bank of Dallas puts the figure at between $6 and $14 trillion solely for the United States. Since then banks have become bigger than ever and the aptly labelled "shadow banking system" has turned the workings of finance even more opaque. Just how much risk has built up in the financial system over the last decade is difficult to tell but the massive rise of leveraged corporate loans was already spooking corporate bond markets before the pandemic hit. There are growing concerns that the massive relief packages in response to the crisis will keep many large and destined-to-fail firms going, even as viable smaller businesses are starved of funds, again transferring dangerous risks from the private to the public balance sheet.

The massive hole in public finances caused by the financial crisis has led to endless rounds of austerity on the false promise that cutting back government spending would release productive resources for the private sector and ignite growth. This has been one important factor in the lack of preparedness to the Covid-19 shock, particularly in the area of public health infrastructure. In the face of underfunded services, public private partnerships have been promoted, with little or no supporting evidence, as a new source of responsible finance.

Growth of jobs and labour incomes was particularly slow, which reinforced the weak recovery and further depressed productivity growth. In many developing countries, high interest rates and overvalued currencies added to "premature deindustrialisation" pressures. It took a full decade for the global unemployment rate to return to the pre-crisis level but employment-to-population ratios, a better measure of labour market health, did not recover before the pandemic, neither in developed nor developing countries, with many prime-age workers dropping out altogether. Precarious labour contracts have risen sharply in both the North and South. And now we have another crisis on our hands.

The world did not prepare for the Covid-19 pandemic as well as it could have, and the ethos that informed the response to the Global Financial Crisis has something to do with that failure. Epidemiological and economic warning signs have flashed for years.

The threat of zoonotic diseases has been growing since the early 1990s, closely linked to the clearing of natural habitats and their replacement with intensive livestock operations. While scientists and public health specialists have regularly warned of the potential danger vested business interests have downplayed the health risks of deforestation and industrial farming for fear it might damage their bottom lines while consumers, particularly in rich countries, have become addicted to cheaper meat. The financial resources needed to control the spread of zoonotic diseases now appear small change in comparison with the costs of the crisis. And the most vulnerable are, again, disproportionately hit.

Economists refer to the transfer of private risk to the general public as moral hazard; the privatization of profits and the socialization of losses an inevitable corollary. Moral hazard was, of course, what brought the global financial system to its knees in 2008, via banks that turned their privileged position as purveyors of private credit into a gigantic speculative bubble. The hazard was a moral one because insiders knew their elite windfall would give way to economic fallout for the community at large. Tragically, this attitude continued after the crisis, encouraged in part by the actions of central banks and what one astute observer of the last decade has described as a "persistent fealty to so much of the pre-crisis conventional wisdom".

Opening up to another lost decade

The global economy had entered dangerous waters by late 2019. Growth was slowing across all regions with a number of economies contracting in the final quarter. Still, there was a widely shared expectation that things would improve in 2020, led by an expected rebound in the large emerging economies, with global growth returning to its long-run potential in 2021. Even with contagion from Covid-19 picking up pace, G20 finance ministers meeting in Riyadh in the last weekend of February, were still sounding an optimistic note on global economic prospects.

Lockdown has parachuted economists into unfamiliar territory. The current situation is not like a war economy where a switch to military spending sees output expand. Nor is it a traditional global supply-side shock where inflationary pressure is the big challenge for policy makers. Nor do we face a financial crisis where the banking sector is in the eye of the storm. In a global health crisis, putting lives before profits has triggered a series of simultaneous and mutually reinforcing supply, demand and financial shocks.

In the wake of these shocks the global economy will contract by an estimated 4.3 per cent this year, leaving global output by year's end over $6 trillion short (in current US dollars) of what economists had expected it to be before the Covid-19 pathogen began to spread. In short, the world is grappling with the equivalent of a complete wipeout of the Brazilian, Indian and Mexican economies. And as domestic activity contracts, so goes the international economy; trade will shrink by around one fifth this year, foreign direct investment flows by up to 40 per cent and remittances will drop by over $100 billion.

The biggest falls in output will be in the developed world, with some likely to register a double-digit decline. But the greatest economic and social damage will be in the developing world where levels of informality are high, there is continued reliance on a few commodities or tourism as a source of foreign exchange, and fiscal

and policy space is limited. Latin America is likely to be very hard hit with a drop in output this year of 7.6 per cent with particularly large declines, possibly double digit, in some of the largest economies, notably Argentina and Mexico. The contrast with East Asia, where growth will remain in positive territory, albeit much lower than in 2019 – China, for example, is expected to grow at 1.3 per cent – is stark.

The massive relief packages adopted mainly by advanced economies – estimated to date at a staggering $13 trillion for G20 countries – have helped to mitigate the decline and with the lockdown easing a recovery will be registered in the second half of the year barring a second round of lockdowns. Given that the fiscal side of these packages is stronger than after the last crisis – accounting for 4 out of every 10 dollars in advanced economy packages including direct payments to households – and because East Asian economies will ride out the economic storm better than expected, the global downturn is not likely to be as harsh as some forecasts suggested earlier this year.

Even so the technical bounce in the second half of this year, as countries begin to emerge from lockdown, will coincide with continuing job losses and rising debt distress. With current relief packages expected to wind down or end altogether by the end of this year the big question is what to expect in 2021. A full V-shaped recovery – the best-case scenario under the circumstances – with annual growth next year above 5 per cent and the world economy returning to its 2019 level by end of 2021 is what many are hoping for. However, even this outcome would leave a $12 trillion income shortfall in its wake and an engorged debt burden, particularly in the public sector.

Our own assessment also sees the bounce continuing into next year albeit with stronger headwinds weakening the pace of global recovery which will, under the best scenario, struggle to climb above 4 per cent. A mixture of higher inequality, greater insecurity and ongoing uncertainty will hold back aggregate demand, shaky corporate balance sheets in advanced countries will damage investor confidence, while a combination of lower tax revenues and higher public debt will – absent appropriate policy support – restrict fiscal space particularly, but not only, in developing countries.

A second generalised lockdown would, inevitably, render any forecast for next year meaningless. But even discounting that possibility there is a very real danger that things could turn out a good deal worse. In particular, a premature squeeze on public spending would compound efforts by the private sector (both firms and households) to balance their books; if governments opt for fiscal tightening in an attempt to bring down public debt and businesses adopt an aggressive cost-cutting strategy in an attempt to boost exports, the recovery will likely fizzle out next year, with a double-dip recession a real possibility in many countries in 2022.

(Almost) Everyone left behind

As policy makers move from relief to recovery in response to Covid-19 any hope of building resilience to future shocks rests on not repeating the post-2008 mistake of leaving reform for better times. Two key areas where recovery and reform should go hand in hand are income distribution and fiscal space.

In a textbook world, income distribution is a well-rehearsed fiction. Wages are negotiated in markets where everyone has equal bargaining power and the outcome is a wage reflecting each worker's productivity. Only in this narrow sense is income distribution "fair". In the real, hyperglobalized world of austerity and depressed employment, corporations wield unique power in wage negotiations and the textbook foundations of fairness in distribution melt away. Even so, any rise in inequality from more liberalizations is justified assuming that the gains from improved allocation of resources, empowered middle-class consumers and improved government revenues would be more than enough to compensate those at the bottom.

That conclusion requires dubious assumptions, like full employment everywhere and at all times. It also misses the point. Power and policies, not fair competition, determine how adjustment processes play out. The playing field is not level. The rise of footloose capital, and its greater freedom to move production and

investment around the globe, has over recent decades strengthened the bargaining power of capital compared to that of labor. This has triggered a steady increase in the share of income going to profits that began well before the global financial crisis but continued after it. In the last decade, the profit share has increased in all but three G20 countries. If these pre-Covid-19 forces of wage repression remain in place, the labor share will likely continue its decline in many economies in the next years exacerbating inequalities. In the United States, after a 50-year descent, the labor share is now back to its 1950s level; if current trends continue, in ten years' time it will be back to the brink-of-the-abyss level of 1930.

Pinning the blame for inequality on job-stealing robots and, more generally, technological advances, is simplistic. At least two other factors, determined by policy choices, have played significant roles. One is hyperglobalization. Research has shown that trade and investment liberalizations have adversely affected wage growth in developed and developing countries, by driving up competition for export shares and promoting cost-cutting at the expense of long-term investment. Flimsy or almost non-existent protection for millions of migrant workers also drives down wages. The other factor is a wide-ranging weakening of labor market institutions – such as unionization, minimum wage and employment protection legislation – in most developed and many developing countries.

Data reveal a deeper cause of this imbalance: the fissuring of many economies into two unequal classes: one made up of a large number of low-wage, low-productivity jobs and one consisting of a small number of high-wage high-productivity sectors. A similar dualistic pattern is familiar in developing countries which have long strived to transfer resources from agriculture to manufacturing. But 21st century dualism is newer for countries, both developed and developing, where parts of the service sector are creating more jobs and, at the same time, experiencing a fall in wages and productivity. While manufacturing and high-wage services provide relatively fewer jobs, growth in low-wage, low-productivity employment does not replace the lost income. Overall economic growth and productivity growth suffer: in most G20 countries – including the United States and all the BRICS – productivity slowed down after the global financial crisis and in some countries productivity was lower in 2019 than in 2009. In the United States productivity grew 17 percent in the 1999–2009 decade but only 12.5 percent in the last decade; China's impressive productivity growth of 162 percent in the earlier decade came down to 99 percent in the last decade. When combined with financialization and heightened corporate power, this economic fissuring generates instability by driving countries into a spiral of slowing aggregate demand and growing financial fragility.

A sustainable recovery requires faster wage growth for low-wage jobs too in order to revive productivity and employment growth. Wage repression and ever weaker labor market rules are only going to make the world economy's pre-existing conditions worse.

Borrowed time, limited space

With footloose capital holding back productive investment and extractive corporate power driving economic polarization, it is little wonder we have entered an age of deep-seated anxiety and increasing anger. With the social contract fraying, governments and households have turned to debt to keep themselves afloat and fractured communities together. But debt is as much a solvent as it is a glue. The threat of economic breakdown hangs ominously over debt-dependent economies. Anxiety turns to foreboding as the logic of extraction moves from the social to the natural world; and while there is a chance that bankrupt families and firms can work through their insolvency, there will be no return for an environmentally bankrupt planet. All the remedies require a stepwise scaling up of long-term public investments and dedicated strategic planning.

The post-2008 turn to austerity was premised on a belief, hard-wired into conventional economic thinking, that crises are exceptional. In normal times, free, flexible markets succeed in keeping the economy at, or close to, its optimal level, with only minimal public intervention. Distortion and abnormality are the product of government interference. The result is a reluctance or unwillingness to actively reverse the destruction of productive capacity incurred during crises and recessions, or to mitigate the distortions generated by financial markets, which discourage long-term productive investments. Together with the dismantling of

permanent and counter-cyclical welfare structures, in the name of efficiency, those assumptions have not only undermined the ability of policy-makers to prevent crises in the real economy, but also – at this moment – to respond more effectively to health crises.

The tendency is not only to underestimate the costs of contractionary policies but also the potential benefits from expansionary fiscal policy, in the name of preserving a market-friendly notion of financial "credibility". Borrowing conditions attached to IMF programmes tend to mimic this contractionary bias.

Austerity always has a contractionary effect on growth and, absent a large enough current account surplus, drags the private sector into debt. Conversely, a stimulus can be self-sustaining and produce the result fiscal hawks long for in a better and faster way. Fiscal contraction does not guarantee a country's public debt sustainability. Indeed, especially in weaker economies, fiscal deficits have often derived from government's squeezing of the private sector, which results in lower tax receipts and higher unemployment. Nor has austerity rewarded its adherents with reliable access to financial markets. Among G20 countries, Argentina, Brazil, India, Mexico and South Africa have all implemented austerity in the past years but are now struggling to access reliable sources of finance. In the Eurozone, the late intervention of the ECB proved once again that it is not fiscal discipline but central bank liquidity that can tame the markets, while fears of inflation have long turned into efforts to encourage it.

Fiscal space is not a matter of accumulating funds for a rainy day, which makes little macroeconomic sense, but of access to stable and affordable financial resources – taxes and debt – which is a matter of history and politics, as well as economics. This has been made abundantly clear during the Covid-19 crisis. Central banks, rather than simply defending a notion of independence that protects the status quo, should combine their function of lenders of last resort with more active management of the credit system that protects, rather than limits the space for domestic fiscal policy. This will, no doubt, require their closer collaboration with other areas of economic policy making. However, sometimes, and especially in developing countries, where fiscal space is constrained by external factors, measures must be put into place at the international level in order to reinforce, or substitute action by the domestic monetary authorities. The response of the multilateral system to the Covid-19 shock has, to date, exposed serious shortcomings in this respect.

Whether or not the current crisis pushes that system, established at the end of World War Two, closer to the brink of implosion or begins a new chapter of international cooperation is, no doubt, closely tied to shifting political currents in the major economic powers. What seems certain is that avoiding a doomsday scenario will require planning for a different future while tackling the current crisis, in all its dimensions. That was the same challenge facing the original architects of multilateralism and given the scale and depth of the Covid-19 crisis, it is not unreasonable to ask today`s leaders to take a harder look at the class of 1945.

Birthday blues

On the twenty fourth of June 1945, following two months of deliberations, over 800 delegates from 50 countries gathered in San Francisco's Herbst Theatre to endorse the idea of a United Nations. Its Charter remains one of the abiding achievements of the 20th century, indeed any century, and its aim, set out forthrightly in its opening paragraphs was to harmonize the actions of nations through friendship, respect, justice and cooperation in the attainment of common ends.

The United Nations has over the intervening 75 years expanded its membership and mandate with an extended – though not always happy – family of institutions and agencies tasked with promoting the virtues of international cooperation. Time, however, has taken its toll on the multilateral project. Talk of a crisis is commonplace even as the need for global solutions to global problems has become more urgent than ever. A mixture of moral suasion, technical expertise and trust-building have been the principle levers for advancing the multilateral agenda, but in a world composed of unequal states, the actions and attitude of the most powerful matters a lot if international cooperation is to work at all.

Such actions had not worked out so well for the League of Nations. But by 1945 the United States was economically and politically in a position to assume a hegemonic role. It was also armed with an ideological vision that was neither wedded to a highly ideological notion of free trade, nor deeply rooted in the values of a colonial past. And the United States had already clipped the wings of its own financial class, tamed corporate power, and forged new relations with neighbouring countries.

The intellectual foundations of the New Deal, from its inception, was based on two basic ideas. Roosevelt defined interdependence, the first one, as "our mutual dependence one upon another – of individuals, of businesses, of industries, of towns, of villages of cities, of state, of nations". This notion was a close cousin to the second big idea behind the New Deal, social justice, and mutual responsibility within nations. At Bretton Woods, Roosevelt made clear that these ideas were ripe for extension to the international level:

> Economic diseases are highly communicable. It follows, therefore, that the economic health of every country is a proper matter of concern to all its neighbors, near and distant. Only through a dynamic and a soundly expanding world economy can the living standards of individual nations be advanced to levels which will permit a full realization of our hopes for the future.

And the following year in San Francisco, the link between economic interdependence, international peace and social justice became the basis on which the United Nations was established.

In practice, multilateralism in the three decades after San Francisco never lived up to the ideals of the New Deal. Managed capitalism coexisted with a persistent and widening technological divide between North and South, wasteful military spending under a tense East-West divide with proxy wars crippled economic prospects in many developing regions, colonialism and lingering racial prejudice, unequal trade relations that inhibited productive diversification in many countries, and carbon-heavy growth that was heedless of the environmental cost.

Relying on the dollar to ensure financial stability was a sticking point at the Bretton Woods conference given its creditor bias and reliance on the US Federal Reserve to accommodate the financial needs of a growing global economy, in a context of strictly regulated capital flows and exchange rates. That role has been steadily augmented since the early 1970s but in the context of a much more volatile international financial environment dominated by massive private capital flows, where the Fed's actions carry greater spillover effects, particularly on developing countries.

Despite its faults, the core principles of Bretton Woods did provide a rough template for a more balanced form of economic development in an interdependent world and provided a platform for a new generation of leaders from the South to break the bondages of colonialism and strive for a more inclusive international economic order. Those efforts ended with the economic dislocations and debt crises of the 1970s and early 1980s. Over the last four decades interdependence has given way to hyperglobalisation as the guiding narrative of international relations, in which the territorial power of strong states has become intertwined with the extra-territorial power of footloose capital. From the perspective of the less powerful, this state of affairs is more a mercantilist jungle than the open plains on which friendship, respect, justice and cooperation can flourish. Multilateralism has struggled to adapt and reforms, while regularly promised, have been resisted by thestrongest players.

Capture of state power was the essence of the mercantilist game that Smith railed against in *The Wealth of Nations*. He would be less than pleased to find it was still a threat to wellbeing in the 21st century and deeply perplexed to find this game now wrapped in the mantle of free trade, with his own name stamped on the lid. The answer to the puzzle lies, in part, with the way the language of "free trade" has been captured by big banks and multinational corporations to push for "deeper integration" that justifies efforts to rewrite the rules of standard-setting and intellectual property protection and reducing the regulatory reach and policy space available to democratically elected governments. All of this and more has been codified in bilateral, regional and multilateral treaties with disputes taken out of the hands of national jurisdictions.

The economic damages from rigging the rules of the game are not the end of the problem. The concentration of economic power is politically corrosive. National constitutions instruct legislatures to make and enforce the same rules for everyone, whether operating within or without a corporation. The response to the global financial crisis suggested otherwise; banks were bailed out and austerity hits jobs, wages and public services while financial asset holders made further gains from recovery. Trust in the structures designed to set policy priorities, manage trade-offs and mediate between different interests diminishes if political and economic connections favour one group over another.

Even so, 2015 was a good year for the international community. In September, the UN General Assembly unanimously endorsed an ambitious agenda of transformative change and a couple of months later a comprehensive programme to address climate change was adopted in Paris. But, with the rules of hyperglobalisation still firmly in place and even before the current crisis hit, both were facing severe head winds and were, on some assessments, already being blown off course.

The great escape, part 1: embrace bold ideas

The Covid-19 crisis is adding new threats and deepening existing fissures to an already anxious world. The damage will be severe, particularly in developing countries where fiscal space is being compressed under a mountain of unsustainable debt, the room for monetary policy is restricted by external pressures and the informal economy is unable to lift itself up by its own bootstraps. This crisis has shattered policy myths, to be sure. But it has also opened new horizons. The *Financial Times* has laid down the challenge with a call for radical reforms that reverse the prevailing policy direction of the last four decades:

> Governments will have to accept a more active role in the economy. They must see public services as investments rather than liabilities, and look for ways to make labour markets less insecure. Redistribution will again be on the agenda; the privileges of the elderly and wealthy in question. Policies until recently considered eccentric, such as basic income and wealth taxes, will have to be in the mix.

The first thing to get right is avoiding the mistakes of the last crisis. That means maintaining an expansionary macroeconomic policy stance, appropriately balanced between its monetary and fiscal components, for as long as it takes the private sector to regain its confidence to spend, including, in particular, a strong investment drive. Avoiding a lost decade will require governments, particularly in the advanced countries, to stick to deficits for several years ahead.

A commitment to full employment in advanced economies and a targeted reduction in informal employment in developing countries should act as measures of policy ambition and success. A big public investment push will be needed with a variety of supportive policies used to complement expansionary measures including job guarantees and public works programmes. Tying these measures to a low-carbon future should be a given.

Central banks have, since the last crisis, moved away from a singular focus on inflation targeting into wide-ranging fire-fighting. This approach has continued in the current crisis with their direct lending to the private sector. Credit management will also need to get more nuanced; in terms of recovery, where possible, the real interest rate should be pushed further into negative territory, a measure that effectively cancels part of the principal of debt and, through this, stimulate firms, individuals and the government to borrow and spend. Central banks will also need to reassert their regulatory authority, including over the shadow banking system, to tame boom-bust credit cycles and broaden their financial risk horizon to include threats, such as climate change, from outside the financial system itself.

However, there is more to recovering better than getting macroeconomic policy right. Governments have broken important political taboos – debt in Germany, for example, but also tentative quantitative easing in some emerging economies – to keep things going during the lockdown and that same attitude will need to persist into the recovery and rebuilding stages. A focus on raising productivity growth will require various

industrial and innovation policies, including more collaborative projects; as the response to develop a vaccine for Covid-19 demonstrates international cooperation can pay big dividends. But incomes policies that tie wages more closely to productivity and target, in particular, a boost to low incomes and active labour market policies that support job mobility can also be designed to boost productivity levels. Again, the need to make fighting climate change an intrinsic design feature of these measures needs little justification.

Intrusive trade rules, promoted under the banner of "deep integration", are a threat to recovery. A temporary "Peace Clause" in the WTO and in the FTAs on pandemic-related government actions would enable countries to quickly adopt and use emergency measures to overcome intellectual property, data, and informational barriers. A permanent standstill in all relevant fora on claims against government measures implemented in the context of Covid-19 would help create the necessary policy space to support recovery efforts. An immediate moratorium on ISDS cases by international corporations against governments using cross-border investment treaties, and a permanent restriction on all Covid-19 related claims, are also needed. New issues, such as digital rules which are being negotiated by a group of countries under Joint Statement Initiative, should not be multilateralised until their development dimension is thoroughly discussed in the appropriate independent fora, such as UNCTAD, and a consensus reached.

Moving forward, concluding the Doha Development Agenda would be a way to restore trust in the trading system with a commitment to special and differential treatment as a prerequisite for ensuring a fair outcome. The Covid-19 crisis has, moreover, highlighted the need for more resilient production systems and a degree of "strategic autonomy" within the international division of labour; that can only happen if countries have the policy space to diversify their economies and add domestic value.

Given the serious tensions hampering the workings of the international trading system, now would be a good time to establish an independent commission to examine whether the WTO`s 25 year negotiating record has fulfilled the principles of the Marrakesh Agreement. The preamble to this agreement, which laid the basis for the WTO's creation in 1995, bears the unmistakable signs of a pact as yet unfulfilled. It speaks of "ensuring full employment", and "a large and steadily growing volume of real income and effective demand", and the importance of "sustainable development" consistent with different levels of development. It is time to reflect on whether the world has lived up to those ideals.

Strengthening the tax base is a necessary condition for expanding fiscal space. Measures that successfully raise wages will automatically boost tax revenues but even a small change in higher income and corporate tax brackets can generate significant gains, not only in advanced economies. In light of the further increase in inequality resulting from this crisis the case for a wealth tax seems irrefutable. Still, the timing of changes in tax codes will be important and should reflect local circumstances. Other taxes and subsidies need also to be re-visited, including the trillions of dollars devoted to subsidizing fossil fuels and industrial farming. For developing countries, in particular, the challenge of expanding fiscal space will require concerted international support.

In the short-run alleviating balance of payment pressures through a large allocation of SDRs is the most feasible and least burdensome option; UNCTAD has proposed anywhere from 1 to 3 trillion depending on whether or not revisions in the allocation are also made to facilitate political agreement. In addition, debt moratoria and short-term debt relief are essential to avoid liquidity crises turning into serial solvency crises. The G20 Debt payment suspension initiative (DSSI), currently underway, while providing welcome breathing space to just over 40 of the 73 eligible countries that have so far signed up to it, is likely too little and too short.

Further measures will be required to bring on board private as well as multilateral creditors, to broaden the scope of such initiatives to a wider range of countries in need at their request and to extend their duration, as well as to move from debt moratoria to debt relief where required. Given the wide reach of private credit rating agencies and their decisive role in either facilitating or hampering progress on debt moratoria and relief, the time has come to proactively engage with the establishment of a publicly controlled credit rating agency.

Boosting international liquidity will only be partially effective if international financial markets are left unregulated. Volatile international capital flows generate cycles that increase the financial fragility of receiving countries, especially in the developing world. Insulating measures, including capital controls, will need to be country specific, determined by the nature and degree of a country's financial openness and by the institutional set-up of its financial system. To enhance the effectiveness of these domestic policies, capital-account management should be kept out of the purview of regional and bilateral trade and investment agreements. Moreover, capital controls will be most effective if capital flows are controlled at both ends, i.e. in both sending and receiving countries.

The great escape, part 2: reform the global architecture

These measures which are aimed at relief and kick-starting recovery harbour deeper reforms in the multilateral architecture that will be needed to sustain recovery and build resilience.

Reining in corporate power is a prerequisite for recovering better. Anti-trust measures are now very much on the agenda at the national and regional levels. But existing multilateral agreements such as the UN`s Equitable Principles and Rules for the Control of Restrictive Business Practices adopted by the General Assembly in 1980, should be strengthened and operationalised with appropriate institutional support such as a global competition authority. Additional actions, made more urgent by the current crisis, regarding the price gauging, patent abuse and other anti-competitive practices of pharmaceutical giants and digital platforms, are warranted to ensure the recovery is both fair and resilient.

Clamping down on corporate tax avoidance and evasion and other forms of illicit financial flows can help both to expand fiscal space and address the inequality challenge. Recent estimates suggest that revenue losses, caused by tax-motivated illicit financial flows (IFFs) alone, are in the range of $49-$193 billion, accounting for 2.3 per cent of combined GDPs, respectively, in Latin America and the Caribbean and in Africa. Multilateral efforts towards reforming international corporate taxation require new energy, beginning with a much more concerted effort to clamp down on tax havens in the North, establishing a global asset registry to enable wealth taxes on the super-rich and moving to a unitary taxation system that recognizes that the profits of international corporations are generated collectively at the group level.

Sustainable financing will require vibrant public financing options. At the international level, that means boosting the lending capacity of multilateral development banks. This new lending could come from existing shareholders redirecting environmentally damaging subsidies, for example for fossil fuels and industrial agriculture, to the capital base of these institutions, or from more innovative sources, such as a financial transaction tax, and augmented by borrowing on international capital markets, with a measured relaxing of their fidelity to financial sobriety. In return, these institutions should reassess their policy conditionalities in line with a more sustainable and inclusive development agenda.

At the national and regional level, public and development banks also need more support, with governments wholehearted in their mandates and allowing their banks to lend beyond the extremely narrow parameters of triple-A ratings by the world's big rating agencies. The dual-sized role of credit rating agencies' as both player and umpire in the markets needs also to be revisited, given their impact on banks' abilities to raise capital for further lending.

A Marshall Plan for global health recovery could provide a more dedicated framework for building future resilience. But it should take its namesake seriously. In the first place that means being generous. If the donor community met the 0.7% Official Development Assistance (ODA) target for the next two years that would generate something in the order of $380bn above current commitments. An additional $220bn mobilised by the network of multilateral and regional financing institutions could complete a $600bn support package over the next 18 to 20 months. The money should be dispersed largely as grants but with some room for zero interest loans, the precise mixture determined as the emergency response evolves. Finally, given the multi-faceted nature of the recovery effort, a dedicated agency, drawing, like the Marshall Plan, on the personnel

of existing agencies as well as from the private sector, with local expertise and coordination involved from the outset. Much like the original, a central financing and oversight agency linked to national public agencies through a regional coordination mechanism remains a model to follow.

Finally, a global sovereign debt authority, independent of either (institutional or private) creditor or debtor interests, should be established to address the manifold flaws in the current handling of sovereign debt restructurings. The Covid-19 crisis, and the stumbling efforts by the international community to agree emergency debt suspension and relief measures, have, yet again, put a glaring spotlight on the crippling fragmentation and complexity of existing procedures, the potentially extraordinary powers of hold-out creditors to sabotage restructurings, and the resultant inefficacy of crisis resolutions.

At a minimum, such an authority should provide coherent frameworks and guidelines to facilitate automatic and comprehensive temporary standstills in recognised disaster situations, ensure that long-term developmental needs, including meeting the 2030 Agenda, are systematically taken into account in debt sustainability assessments, and provide an independent forum for expert advice to governments requesting this. In the longer run, it should provide a blueprint for a comprehensive reform of current sovereign debt workout mechanisms to balance creditor and debtor interests fairly, close loopholes for hold-out creditors, and prioritize the long-term collective interests of the many over the short-term financial rewards of the few.

Conclusion

For all its destruction of human and economic life, the novel coronavirus has created an opportunity for lasting change, in part because it has laid bare the shortcomings of the world that existed well before this pathogen made its way around the world. The financial crisis a decade ago did the same, but the world did not rise to the challenge, and we were still living with the vestiges of that failure when the virus leapt from animal to human in late 2019. Now the problems are, if anything, larger. But the intellectual environment around them is much more vibrant, and the political will to attack them shows some promising signs of life. There is reason for hope but not for complacency.

TRENDS AND CHALLENGES IN THE GLOBAL ECONOMY

I

A. Introduction

The global economy ended 2019 in failing health. In early 2020 it suffered a serious cardiac arrest from the initial health shock of Covid-19. As a localized health crisis became a global pandemic, many countries put broad swathes of their economies into a policy-induced coma to halt the spread of the novel virus and ease the burden on strained health systems. As a result, the global economy will experience a recession this year on a scale not experienced since the 1930s.

The trigger for this crisis was a microscopic pathogen with which the global health community is, after a faltering start, grappling, albeit unevenly across countries. The global economic community, however, failed to diagnose the underlying conditions that have made the economic consequences of the health shock so severe. As a result, it failed to respond with either the commitment or ambition demanded by the challenge. Without a large and coordinated response, led by the major advanced economies, any hope of recovering better is likely to quickly fade into a lost decade with deeply disturbing economic, social and political consequences, particularly for the developing world.

Much will depend on whether and, if so, how quickly, a vaccine can be developed. As the first pandemic wave began to recede and the capacity for testing, tracing, and the provision of equipment to respond to subsequent waves of the disease improved, many countries started to relax the lockdowns of their economies in the second half of this year. Some of these moves have proved premature, which will likely prolong the time it will take for the world to get back to some semblance of normal, and obscures what that normal will eventually be. A shock of this scale will certainly have persistent, and likely permanent, effects on the society and the economy. But the future is still open, and building back better is a choice we face; political priorities, policy decisions and collective actions, not epidemiological destiny, will determine the future.

Drawing on the ideas and proposals presented in previous editions of the *Report*, this year's *Report* analyses the economic impact of Covid-19 and possible responses that could be both effective and inclusive. It examines different recovery scenarios and, in particular, highlights the danger of a lost decade (chapter II), addresses immediate difficulties facing developing countries as they well as some of the underlying conditions that, if left unaddressed, will prevent a better recovery (chapters III and IV). It also discusses some of the institutional changes needed at the international level to bolster recovery and transition to a more socially caring and environmentally sustainable global economy – a transition that the world needed before the pandemic but has become ever more pressing (chapter V).

B. The world economy in 2021: Through a glass darkly

We start with what is a particularly difficult task in times of extreme uncertainty, predicting the future. This chapter describes the first impact of Covid-19 on the global economy and its recovery prospects. Before the pandemic, most analysts had expected world output to accelerate in 2020, pulled by faster growth in some of the larger developing economies, even as advanced economies continued their sluggish growth performance (IMF, 2020a, 2020b and 2020c). The pandemic has forced a reappraisal. As of mid-2020, the expectation of most private-sector, government and multilateral institutions is

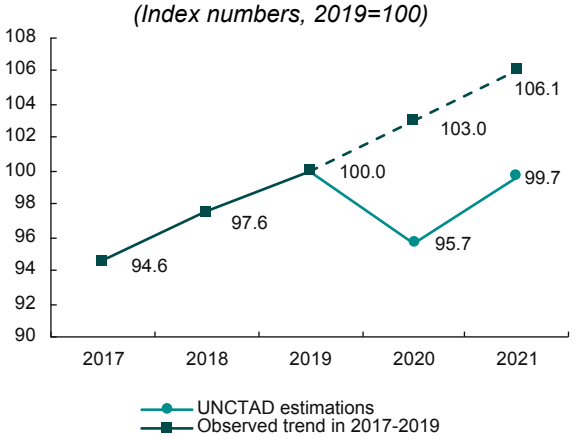
a sharp contraction of the world economy this year, concentrated in the first half of 2020, followed by an incomplete recovery, starting in the second half of 2020. As measured by annual growth rates, the recession in 2020 will be much deeper than after the global financial crisis (GFC). Assuming that a second lockdown is avoided, the recovery is expected to continue through 2021, although world income is still unlikely to reach its pre-Covid-19 level by the year's end.

UNCTAD sees a similar pattern of a deep global recession followed by a technical bounce (as lockdown eases) and an initial recovery for this year but a full V-shaped recovery depends on policymakers doing everything right (figure 1.1), a far from certain prospect. And there are reasons to be worried about the pace of recovery next year, not only because of the non-negligible risk of new waves of the disease, but also because of the high uncertainty about the direction of economic policy and the absence of timely multilateral support on a scale commensurate with the challenging circumstances, particularly in developing countries, leading to deeper and more lasting damage from the Covid-19 shock. It is, moreover, important not to forget, as the attention of policymakers is absorbed by the health crisis and its consequences, that the geo-political tensions brewing before Covid-19, and the climate emergency which has been longer in the making, will continue to shape future outcomes.

UNCTAD baseline scenario, simulated through the United Nations Global Policy Model (GPM), and assuming the policy response this year is properly targeted and continues in to 2021, indicates a 4.3 per cent reduction in world output in 2020 and a 4.1 per cent expansion next year (table 1.1). Compared to the average expectations of public and private institutions as of mid-2020, our scenario suggests a less severe downturn this year, but a weaker recovery next year. For example, in the latest update of its World Economic Outlook, in June, the IMF indicated a 4.9 per cent contraction in 2020 and a 5.5 per cent expansion in 2021, in terms of purchasing power parity (PPP) (IMF, 2020c).

In quantitative terms, considering that the average growth rate of the world economy – the pre-Covid-19 trend – was 3.0 per cent in 2017–19, UNCTAD baseline scenario means that world income will still be 6.4 per cent below its pre-Covid-19 trend in 2021 (figure 1.1). Measured in terms of world gross product (WGP), the Covid-19 recession will likely amount by end of 2021 to a $12 trillion loss in global income, relative to a simple projection of the 2017–2019 trend,[1] far larger than the TDR update expected in early March 2020 (UNCTAD, 2020). Moreover, the growth recovery in 2021 will coincide with rising unemployment, which is likely to reach double digits in some advanced economies.

FIGURE 1.1 World output level, 2017–2021
(Index numbers, 2019=100)



Source: UNCTAD secretariat calculations, based on United Nations Global Policy Model.

This baseline scenario anticipates a wide fluctuation of the growth rate of global output in 2020-21, but a full recovery to the pre-Covid-19 trend by 2021 is unlikely for four reasons:

- The world economy had a positive trend growth rate before Covid-19. So, even with an expansion by 4.1 per cent in 2021, global income will not recover, in that single year, to the level expected before the pandemic.

- The massive income losses of firms and families from Covid-19 have, and will continue to have, a negative impact on savings and income, raising private debt levels. This build-up of debt lowers the chances that private spending will return to its pre-pandemic levels quickly.

- Central banks reacted quickly to the Covid-19 and seem to have averted a global financial meltdown. But the evidence from the GFC shows that monetary policy alone cannot bring the economy quickly back to its pre-shock situation. Fiscal stimulus is needed; the scale and composition of that stimulus will have a significant bearing on the trajectory of recovery.

- Based on what happened after the GFC, the necessary increase in government deficits and debt to fight the crisis may be prematurely aborted by fiscal consolidation; this could happen as soon as mid-2021 in many countries, which in its turn would slow down the return to full economic recovery or even reverse it.

TABLE 1.1 World output growth, 1991–2021
(Annual percentage change)

Country groups	1991–2000[a]	2001–2008[a]	2009–2018[a]	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019[b]	2020[b]	2021[b]
World	**3.0**	**3.6**	**2.9**	**-1.3**	**4.5**	**3.3**	**2.8**	**2.7**	**3.0**	**3.0**	**2.7**	**3.3**	**3.1**	**2.5**	**-4.3**	**4.1**
Developed countries *of which:*	**2.7**	**2.3**	**1.6**	**-3.4**	**2.6**	**1.6**	**1.2**	**1.3**	**2.0**	**2.4**	**1.7**	**2.5**	**2.3**	**1.8**	**-5.8**	**3.1**
Japan	1.2	1.2	1.0	-5.4	4.2	-0.1	1.5	2.0	0.4	1.2	0.5	2.2	0.3	0.6	-4.5	1.9
United Kingdom	2.9	2.6	1.7	-4.3	2.0	1.5	1.5	2.1	2.6	2.4	1.9	1.9	1.3	1.4	-9.9	4.4
United States	3.6	2.6	2.0	-2.5	2.6	1.6	2.3	1.8	2.5	2.9	1.6	2.4	2.9	2.3	-5.4	2.8
European Union (EU 27) *of which:*	2.1	2.1	1.1	-4.4	2.2	1.9	-0.7	0.0	1.6	2.4	2.1	2.7	2.1	1.5	-7.3	3.5
Euro area	2.1	1.9	1.0	-4.5	2.2	1.7	-0.9	-0.2	1.4	2.1	1.9	2.5	1.9	1.2	-6.9	3.4
France	2.0	1.8	1.0	-2.9	1.9	2.2	0.3	0.6	1.0	1.1	1.1	2.3	1.7	1.3	-8.1	3.4
Germany	1.6	1.3	1.6	-5.7	4.2	3.9	0.4	0.4	2.2	1.7	2.2	2.5	1.5	0.6	-4.9	2.9
Italy	1.6	0.9	-0.3	-5.3	1.7	0.7	-3.0	-1.8	0.0	0.8	1.3	1.7	0.8	0.3	-8.6	3.2
EU member States after 2004	1.9	5.0	2.4	-3.5	1.5	3.2	0.8	1.2	3.0	4.0	3.1	4.8	4.4	3.7	-5.3	3.9
South-East Europe and CIS	**-4.8**	**7.2**	**1.8**	**-6.2**	**4.6**	**4.8**	**3.5**	**2.5**	**1.1**	**-1.5**	**0.9**	**2.2**	**2.8**	**2.2**	**-4.3**	**3.5**
South-East Europe[c]	-0.6	5.5	1.6	-1.9	1.6	2.0	-0.5	2.5	0.3	2.5	3.2	2.5	4.0	3.5	-3.2	3.6
CIS incl. Georgia *of which:*	-4.9	7.3	1.8	-6.4	4.8	4.9	3.7	2.5	1.2	-1.7	0.8	2.2	2.8	2.2	-4.3	3.5
Russian Federation	-4.7	6.8	1.2	-7.8	4.5	4.3	3.7	1.8	0.7	-2.3	0.3	1.6	2.3	1.3	-4.2	3.4
Developing countries	**5.1**	**6.6**	**5.1**	**3.1**	**7.9**	**6.2**	**5.4**	**5.0**	**4.7**	**4.3**	**4.3**	**4.6**	**4.3**	**3.5**	**-2.1**	**5.7**
Africa	2.5	5.8	3.0	3.9	5.4	-0.7	7.6	1.1	3.1	2.6	1.7	3.5	3.1	3.1	-3.0	3.5
North Africa (incl. South Sudan)	3.1	5.4	0.9	3.8	4.0	-10.1	12.0	-6.1	-0.7	1.7	2.8	5.1	3.3	4.1	-3.4	3.6
Sub-Saharan Africa (excl. South Africa and South Sudan)	2.1	6.6	4.8	5.7	7.2	5.7	6.0	6.0	5.9	3.4	1.4	3.0	3.6	3.3	-2.1	3.6
South Africa	2.1	4.4	1.8	-1.5	3.0	3.3	2.2	2.5	1.8	1.2	0.4	1.4	0.8	0.2	-6.0	3.0
Latin America and the Caribbean	3.2	3.9	1.7	-2.2	6.0	4.6	2.8	2.8	1.0	0.1	-1.2	1.0	0.6	-0.3	-7.6	3.0
Caribbean	2.1	5.0	2.5	-0.9	3.0	2.3	2.2	2.7	2.6	4.1	1.9	2.2	3.5	1.9	-6.4	2.3
Central America (excl. Mexico)	4.4	4.6	4.0	-0.5	4.0	5.7	5.1	3.9	4.0	4.2	3.8	3.9	2.7	2.6	-5.2	2.6
Mexico	3.2	2.2	2.6	-5.3	5.1	3.7	3.6	1.4	2.8	3.3	2.9	2.1	2.1	-0.1	-10.0	3.0
South America *of which:*	3.2	4.4	1.3	-1.3	6.6	4.9	2.4	3.2	0.2	-1.3	-3.0	0.4	-0.2	-0.7	-7.1	3.1
Argentina	4.0	5.0	1.2	-5.9	10.1	6.0	-1.0	2.4	-2.5	2.7	-2.1	2.7	-2.5	-2.2	-10.4	4.7
Brazil	2.8	3.7	1.1	-0.1	7.5	4.0	1.9	3.0	0.5	-3.5	-3.3	1.3	1.3	1.1	-5.7	3.1
Asia	6.6	7.8	6.2	4.8	8.9	7.6	5.9	6.1	5.9	5.6	5.9	5.6	5.3	4.4	-0.9	6.3
East Asia *of which:*	8.9	9.2	6.9	7.2	9.8	8.4	6.8	6.9	6.6	6.0	6.0	6.2	5.9	5.4	1.0	7.4
China	10.6	10.9	7.8	9.4	10.4	9.6	7.9	7.8	7.3	6.9	6.7	6.8	6.6	6.1	1.3	8.1
Republic of Korea	6.6	4.9	3.2	0.8	6.8	3.7	2.4	3.2	3.2	2.8	3.0	3.2	2.7	2.0	0.1	4.3
South Asia *of which:*	4.8	6.7	5.9	4.0	8.7	5.6	3.4	4.7	6.2	6.1	8.5	6.3	5.1	2.8	-4.8	3.9
India	5.9	7.6	7.0	5.0	11.0	6.2	4.8	6.1	7.0	7.5	9.0	6.6	6.8	4.2	-5.9	3.9
South-East Asia *of which:*	4.9	5.7	5.1	2.0	7.8	4.9	6.0	5.0	4.5	4.7	4.8	5.3	5.1	4.4	-2.2	4.3
Indonesia	4.2	5.2	5.4	4.6	6.2	6.2	6.0	5.6	5.0	4.9	5.0	5.1	5.2	5.0	0.1	4.5
West Asia *of which:*	4.2	5.5	4.2	-1.7	5.8	8.6	4.9	4.9	3.3	4.0	3.2	2.1	2.0	0.9	-4.5	3.6
Saudi Arabia	1.7	4.5	3.7	-2.1	5.0	10.0	5.4	2.7	3.7	4.1	1.7	-0.7	2.4	0.3	-4.8	3.2
Turkey	3.9	5.9	6.0	-4.7	8.5	11.1	4.8	8.5	5.2	6.1	3.2	7.5	2.8	0.9	-4.6	4.0
Oceania	2.9	2.9	3.2	2.5	6.1	1.6	2.6	2.8	6.9	4.5	0.8	0.8	1.2	2.6	-3.4	2.9

Source: UNCTAD secretariat calculations, based on United Nations Global Policy Model; United Nations, Department of Economic and Social Affairs (UN-DESA), *National Accounts Main Aggregates database*, and *World Economic Situation and Prospects (WESP): Update as of mid-2020*; ECLAC, 2020; Organisation for Economic Co-operation and Development (OECD), 2020; International Monetary Fund (IMF), *World Economic Outlook*, April 2020; Economist Intelligence Unit, *EIU CountryData* database; JP Morgan, *Global Data Watch*; and national sources.

Note: Calculations for country aggregates are based on gross domestic product (GDP) at constant 2015 dollars.

a Average.

b Forecasts.

c Albania, Bosnia and Herzegovina, Montenegro, Serbia and the Republic of North Macedonia.

Given the last three factors, the baseline scenario of incomplete recovery in 2021 remains tentative. Chapter II of this *Report* presents alternative scenarios, based on different assumptions about the intensity of recovery policies by leading economies and their coordination at the international level.

The fragile state of the world economy going into 2021 should be a wake-up call for policymakers everywhere. There is a high likelihood that if it is not, world output will not follow the V-shaped pattern that many are hoping for or even the stunted V that we see as the more likely outcome. A prolonged recession or U-shaped recovery, a double-dip recession (W-shaped) or a permanent loss of potential output (L-shaped) are all possible trajectories. And just as importantly, the pattern of global recovery can include different trajectories for each country and region. A more detailed discussion of regional trends appears at the end of this chapter.

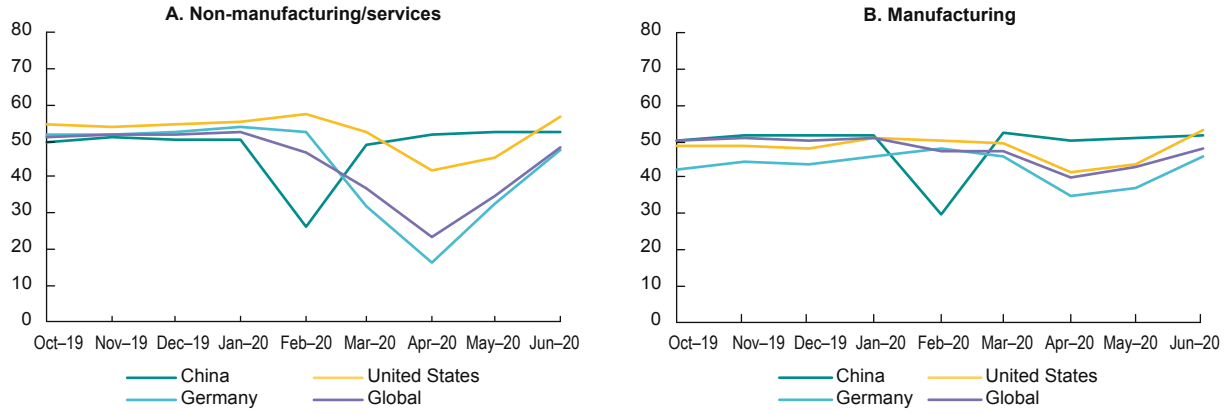
C. Mighty crises from little pathogens grow: The impact of the Covid-19 shock

The pandemic began at the end of 2019, and spread rapidly in the first half of 2020 (WHO, 2020). A growing sense of economic unease was first registered by financial markets in advanced economies in late February, but a sense of panic spread rapidly when markets opened on 8 March. Central banks, led by the Federal Reserve, responded quickly by turning on the liquidity tap to prevent a repeat of the credit crunch of 2008. However, with the disease still spreading and concerns growing about its virulence, prioritizing the lives of the population and the integrity of health systems required locking down economic activity to contain its impact. This response, albeit with national variations in aptitude and discipline, has been more widely adopted in advanced than developing countries, where informal and precarious work conditions restrict its application.

The result has been a massive disruption to global supply, and a concomitant reduction in both consumption and investment demand in the face of income losses and diminished expectations about a swift return to normalcy. The first empirical studies show that, even where social isolation policies were soft, economic activity still fell sharply (Aum et al., 2020; Andersen et al., 2020; Correia et al., 2020), indicating the high degree of interdependence in today's global economy. Anxiety, confusion and uncertainty were just as significant drivers of lower demand in the first half of 2020, as the economic restrictions adopted to slow down the spread of Covid-19.

On the supply side, the containment policies to fight the virus stopped many "non-essential" activities, with a particularly large negative impact on services,

FIGURE 1.2 **Purchasing managers' index, selected economies, October 2019–June 2020**
(Index numbers)



Source: China National Bureau of Statistics (NBS) *Purchasing Managers' Index*; United States Institute for Supply Management (ISM) *Purchasing Managers' Index* and *Non-Manufacturers Survey Index*; Germany *Markit Purchasing Managers' Index*; JPMorgan *Global Purchasing Managers' Index*.

Note: A Purchasing Managers' Index (PMI) greater than 50 represents an expansion compared to the previous month, while a PMI less than 50 represents a contraction, and 50 indicates no change.

especially in hospitality, entertainment, travel and tourism (figure 1.2A). Since for many services a temporary reduction in demand does not necessarily create a compensating spike after isolation – people will not dine out twice in the same day or have two haircuts in the same month – this "service recession" of the first half of 2020 will mean a permanent loss of income for many firms and workers. The threat of bankruptcy, including for otherwise viable firms, is still a very real one (OECD, 2020) with some pointing to the collapse of world tourism as the next stage of the global crisis (Foroohar, 2020).

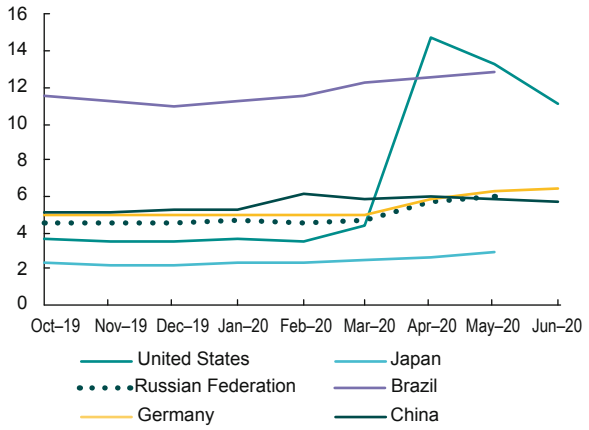
The effects on industry were less intense than in services, but lockdowns still hit output hard in many sectors, especially consumer durables, and there were sharp increases in inventories as consumers and investors cut their demand for non-essential products in response to the crisis (figure 1.2B).

In contrast to non-essential goods and services, essential activities or sectors operated almost at full capacity during the Covid-19 shock. For example, there was a surge in the demand for, and production of, medical equipment all around the world, and the demand for food and basic consumer items also grew during the first phase of the shock, as people stopped eating out and accumulated supplies for fear of worse to come. Supermarkets, drugstores, and their distribution chains operated at peak capacity during the critical phase of the pandemic, creating a two-speed economy, in which part of the population stayed inactive while the other part worked full-time or overtime.

The net impact of the supply shock was clearly negative, reducing employment and income in both advanced and developing economies (figure 1.3). The rise in the rate of unemployment has been attenuated, in part, by the reduction in labour-force participation, due to the usual effects of recession. Moreover, emergency government transfers to workers temporarily without income, predominantly in advanced economies, also allowed millions of people to stay inactive during the period of social isolation. As a result, the ratio of employment to the working age population (figure 1.4) is a better index than the rate of unemployment to gauge the impact of Covid-19 on labour markets.

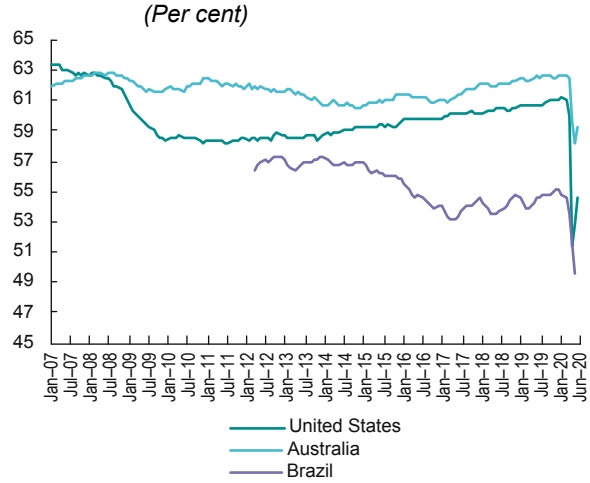
Adding the increase in unemployment to the reduction in the labour force, ILO has estimated that, in the first half of 2020, the pandemic reduced total work hours in an amount equivalent to 435 million full-time

FIGURE 1.3 Unemployment rate, selected countries, October 2019–June 2020
(Per cent)



Source: UNCTAD secretariat calculations based on national sources.
Note: All series are seasonally adjusted, except China.

FIGURE 1.4 Employment-population ratio, selected countries, January 2007–June 2020
(Per cent)



Source: UNCTAD secretariat calculations based on national sources.
Note: All series are seasonally adjusted, except Brazil.

jobs (ILO, 2020). Considering the enterprises at risk from the economic effects of Covid-19, ILO also estimated that 436 million people (47 million employers and 389 million own-account workers) worked in activities most hit by the sudden stop. If economic policy does not rise to the challenge, a shock of this magnitude will have long-run consequences for the growth rate of potential output in many economies, as happened after the GFC. We will return to this in chapters II and III of this *Report*.

According to textbook economics, an adverse supply shock decelerates output and accelerates price rises. In practice, in the first half of 2020, inflation fell or stayed the same for many products because Covid-19

was also a massive negative demand shock. To understand why, it helps to organize the demand impact of the pandemic in to four channels or transmission mechanisms:

- The spontaneous reduction in the consumption of non-essential products and services due to the fear of contagion. This effect was responsible for most of the immediate loss of income and employment in many countries.

- The reduction in private investment due to the fall in current and expected demand. This effect was particularly important in countries that were already experiencing slowdown in growth before Covid-19, with too much idle capacity to justify investment.

- The fall in consumption and investments due to capital losses in financial markets, as investors fled risky assets for government bonds of advanced economies, especially the United States, pushing equity markets down and risk premiums up for government bonds in developing countries and corporate bonds in both advanced and emerging markets.

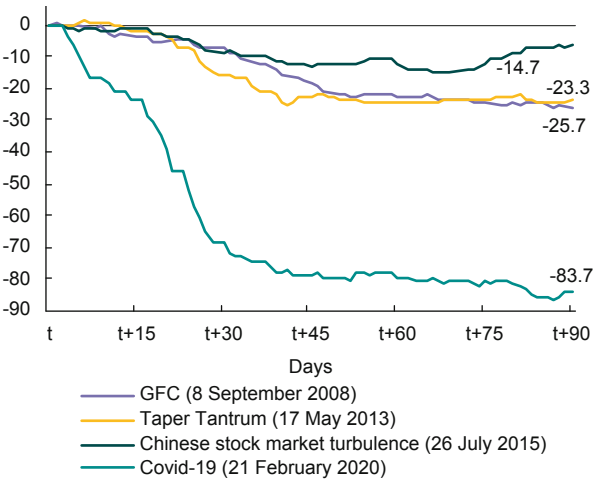
- The increase in financial constraints, as banks raised lending standards and interest-rate spreads in anticipation of higher delinquency rates and higher risk premiums in capital markets, even after a reduction in the base interest rate by central banks.

These four effects inevitably amplified the initial negative supply-side impact of Covid-19 on the economy, and if allowed to persist would have triggered a vicious spiral pulling down income and employment, further damaging confidence and, in the context of already high levels of debt, sowing the seeds of another worldwide financial crisis. However, the central banks and national treasuries of the main economies of the Group of Twenty (G20) quickly stepped in with short-term operations to address initial liquidity shortages and prevent financial markets from freezing up, followed in rapid succession by an extension of longer-term lending facilities to non-financial corporations along with extended support to smaller businesses, the unemployed and furloughed workers.

Mario Draghi, as president of the ECB, famously said he would do "whatever it takes" to preserve the integrity of the euro zone. So far, the strategy of most advanced country governments has been the same to relieve the economic burden of the pandemic – even if questions hang over the size of the fiscal stimulus in some cases – and avoid a prolonged crisis; they have delayed asking "what on earth did we do?" for later (Blanchard, 2020). That commitment is registered in central bank balance sheets which have acquired much larger positions in both public sector and non-financial private sector assets than was the case following the GFC, when operations were focused almost exclusively on bailing out the banking sector. Given the exceptional nature of the shock, this response had merit. There are, however, still serious questions to be asked about: the distributional impact of the relief packages being adopted (Brenner, 2020); their potential to stimulate and sustain recovery (see chapter II); possible capacity constraints in different sectors of the economy, particularly where agriculture is still a significant source of income and in sectors where informality is the norm; and about the massive increase in public debt that recovery involves.

The debt situation was particularly precarious in many developing countries prior to the Covid-19 crisis and some countries have since tipped into default while many others are on the brink (Box 1.1). The non-resident capital flight from developing countries in response to the Covid-19 pandemic was on a far greater scale than in previous crisis episodes.

FIGURE 1.5 Cumulative non-resident portfolio flows to emerging markets after selected global shocks
(billions of dollars)



Source: UNCTAD secretariat calculations based on IFF Daily Emerging Market Portfolio database.
Note: Emerging markets include Brazil, China, India, Indonesia, Mexico, Pakistan, Philippines, Qatar, Republic of Korea, Saudi Arabia, South Africa, Sri Lanka, Thailand, Turkey and Viet Nam. The starting date for each global shock is given between parentheses.

This flight was registered in all developing regions, causing widespread currency depreciations and widening spreads on sovereign bonds (UNCTAD, 2020). Synchronized benchmark-driven portfolio investment strategies and the swift downgrading of developing country debt by credit rating agencies (CRAs) contributed to the size and spread of the shock. A degree of calm has been restored in these markets since April (figure 1.5), largely due to purchases of domestic-currency denominated securities in local capital markets and of international bonds by Asian governments and corporations (Riordan and Hale, 2020). However, in the absence of concerted international action to reduce the debt overhang in developing countries, the return of stormier conditions is an ever-present threat to their chances of recovery (see also chapter IV).

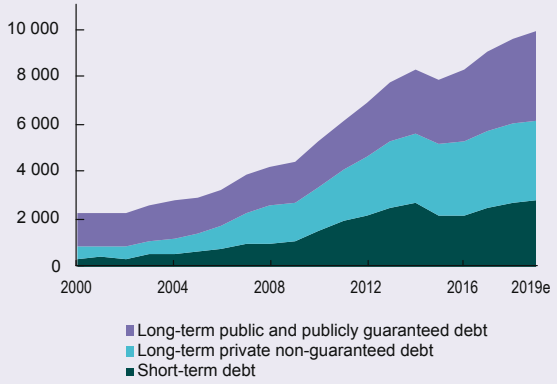
1. Private sector debt: Another crisis brewing?

The heightened debt distress from Covid-19 is not confined to public balance sheets. The debt splurge, in both developed and developing countries, since 2009 has been driven by private borrowing with growing concerns, already flagged in *TDR 2019*, about high and rising corporate debt levels.

BOX 1.1 Debt vulnerability in developing countries

On the eve of the Covid-19 outbreak, the total external debt stocks of developing countries and economies in transition (henceforth developing countries) reached $10 trillion, a new record high, more than double the figure of $4.5 trillion in 2009. Given a global economic environment that continued to be dominated by short-term policy-induced boosts to speculative investor expectations and growing income inequalities rather than a sustained and inclusive recovery of aggregate demand, this rise in external indebtedness was not compensated for by sufficiently strong GDP growth in the developing world. Consequently, the average ratio of total external debt-to-GDP for all developing countries rose from 25 per cent in 2009 to 29 per cent in 2019. This figure rises to an average 38 per cent in 2019 if China's very large developing economy is excluded, owing to its modest ratio of external debt to GDP.

FIGURE B.1 External debt stocks, all developing countries, 2000–2019
(Billions of current dollars)



Source: UNCTAD secretariat calculations based on World Bank, IMF and national sources.
Note: ***e*** estimate.

Rising external debt burdens continued to absorb a growing share of developing countries' resources. Thus, the ratio of total external debt-to-exports rose to 111 per cent for all developing countries, up from 105 per cent in 2018 and back to levels last experienced in 2003. Similarly, debt service burdens continued their upward trend: In 2019, developing countries spent 14.6 per cent of their export revenues to meet external debt obligations, up from 7.8 per cent in 2011, the lowest point in the period of observation. As to government revenues, the average trend has been more modest but persistently upward, rising from its lowest point of 2.7 per cent of government revenues spent on the costs of servicing long-term public and publicly guaranteed external (PPG) debt in 2012 to 4.7 per cent in 2019. This situation is, however, much more severe in many developing countries where more than a quarter of government revenues are absorbed to service PPG debt, including oil exporters hit by the recent collapse in oil prices as well as middle-income developing countries (MICs) with high debt burdens.

Developing countries' external debt positions also became more exposed to shorter maturities and greater roll-over risks. The share of short-term in total external debt rose to 29 per cent in 2019, up from well below 20 per cent in the early 2000s and 26 per cent in 2009. Simultaneously, the ability of developing countries to self-insure against exogenous shocks and increased market risk through international reserve cushions continued to weaken, with the ratio of short-term external debt-to-reserves almost halving from its peak in 2009 at 544 per cent to 279 per cent in 2019. This is of concern in the wake of the Covid-19 crisis, since it signals strong limitations on the ability of developing countries to bridge liquidity crises arising from this shock. Moreover,

effective responses to the Covid-19 shock are complicated by the blurring of the conventional distinction between external and domestic debt in a context of rapid financial integration and open capital accounts. Domestic debt can be held by foreign investors, both domestic and external debt can be denominated either local or foreign currency denominated, and bond debt – whether sovereign or corporate – is traded in secondary and tertiary markets and frequently changes hands.

The single most prominent feature of the recent evolution of overall debt accumulation in developing countries has been an extraordinary increase in private indebtedness, in particular since the onset of GFC (*TDR 2019*). From the point of view of external debt vulnerabilities, this upsurge in private-sector indebtedness carries three main risks: first, private debt contracted in foreign-currency ultimately represents a claim on a country's international reserves, especially where private entities could not hedge their foreign-currency liabilities against foreign-currency assets. Second, even where private debt is denominated in local currency but held by external creditors, sudden reversals in external credit flows can undermine debt sustainability. Third, high domestic private debt (issued in domestic currency and held by residents) represents a contingent liability on public sector finances, if exogenous shocks lead to wide-spread bankruptcies or the creditworthiness of borrowers deteriorates systematically. By some estimates, external creditors hold around one third of non-financial sector corporate debt, amounting to $1.8 trillion, in 26 emerging market economies excluding China, primarily in foreign currency.[2] Of concern is that the proliferation of corporate indebtedness does not appear to have boosted productive investment.

A common driving force behind rising financial vulnerabilities has been the global search by global financial investors for high short-term returns in the context of widespread capital account liberalization in developing economies and the deregulation of international financial markets. This intensified in an environment marked by extensive monetary accommodation and near-zero interest rates in advanced economies, following the GFC. In addition to targeting emerging market foreign-currency denominated securities in high- and middle-income developing economies, issued primarily by their corporations, international financial investors increased their participation in expanding local-currency denominated sovereign bond markets, with foreign holdings in some cases, reaching up to one third of domestic debt.

At the same time, many frontier economies[3] increasingly relied on the issuance of foreign-currency denominated bonds in international financial markets. In sub-Saharan Africa alone, 21 countries had outstanding obligations on sovereign Eurobonds to the equivalent of $115 billion at the beginning of 2020, following a steep increase in their issuance since 2017.[4] Overall, the ownership composition of developing country PPG debt and therefore also its risk profile, has changed substantively since the GFC, with the share of this debt held by private rather than official creditors rising to 62 per cent of the total at end-2018, compared to 46 per cent at end-2009, and the share of this debt owed to bondholders rather than commercial banks rising from 60 per cent to 76 per cent in the same period.

This trend towards heightened financial vulnerabilities has been reinforced by the growth of passively managed, benchmark-driven financial investment strategies since the GFC.[5] These track flagship benchmark indices, such as the JP Morgan EMBI indices for sovereign bonds, the Morgan Stanley MSCI indices for equities and the J.P. Morgan Next Generation Markets Index (NEXGEM), to inform financial investment decisions. The inclusion of many frontier developing economies in these indices has meant that such passive, benchmark-driven private investment strategies have increasingly dominated their access to international financial markets.[6]

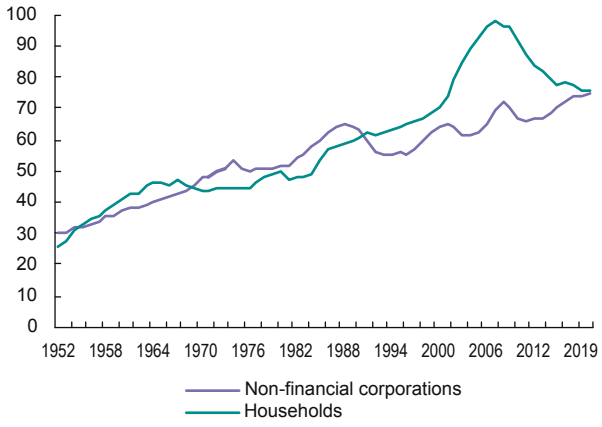
Benchmark-driven financial investment strategies are prone to promoting herd behaviour: The bulk of global investors' financial wealth is managed by a small number of asset funds that focus on developments affecting emerging and frontier economies as a group rather than on country-specific features. They also rely on highly correlated benchmarks indices based on similar methodologies. Consequently, benchmark-driven investment strategies are highly sensitive to shifts in global financial conditions and tend to amplify these by triggering synchronized movements of portfolio flows across developing countries. Their influence is not limited to passive fund management, since active funds aim to outperform passive investment strategies. By some estimates, as much as 70 per cent of country allocations of investment funds are influenced by benchmark indices.[7]

For example, considering the United States, before the pandemic, the credit or debt-GDP ratio of non-financial corporations was already at its highest level since the 1950s. Despite this, the leverage of the whole non-financial private sector in the United States was lower in 2019 than in 2007 because its households reduced their debt-GDP ratio by approximately 23 percentage points since the GFC (figure 1.6). If the firms in the United States try to do the same after the pandemic without a compensatory

move by the Government or households, the United States may enter a race to the bottom, in which everyone cuts spending to reduce debt, ending up in the same or a worse situation.

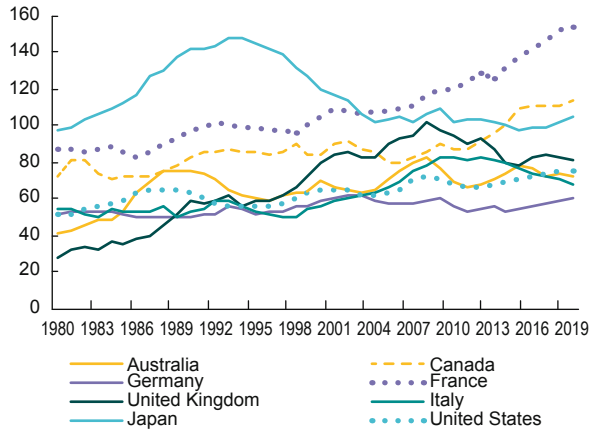
In the United States, the corporate debt-GDP ratio of 74.9 per cent in 2019 – although high by its own standards – was moderate when compared to other advanced economies. Specifically, in Japan, nonfinancial corporate debt peaked at 218 per cent of GDP in the mid-1990s and fell to 163 per cent of GDP in 2019. In the United Kingdom, the same index reached 194 per cent of GDP in 2008 and fell to 164 per cent of GDP before the pandemic. Before Covid-19, the corporate nonfinancial sector also had a debt-GDP ratio higher than 100 per cent of GDP in Canada and France, with an apparent positive trend (figure 1.7).

FIGURE 1.6 Debt-to-GDP ratio in the United States, selected sectors, 1952–2019
(Per cent)



Source: UNCTAD secretariat calculations based on Bank of International Settlements (BIS) database.

FIGURE 1.7 Debt-to-GDP ratio of the non-financial corporate sector, selected developed countries, 1980–2019
(Per cent)



Source: see figure 1.6.

Similar to public finances, the sustainability of corporate debt depends on the growth rate of the economy and the real interest rate paid. A high debt-GDP ratio can be non-explosive if the real interest is relatively low, when compared to GDP growth, as seems to be the case in Japan. A low debt-GDP ratio can be explosive if the opposite happens and, most importantly, a change in leverage of the corporate sector may be compensated or magnified by the change in the debt-GDP ratio of households and/or the government. Because of the latter, it is useful to analyse the change in debt ratios of the whole non-financial private sector as a measure of stability in private finance.

Considering the evolution of the G20 economies since 2011, the BIS data show a mixed picture for nonfinancial corporations since (figure 1.8):

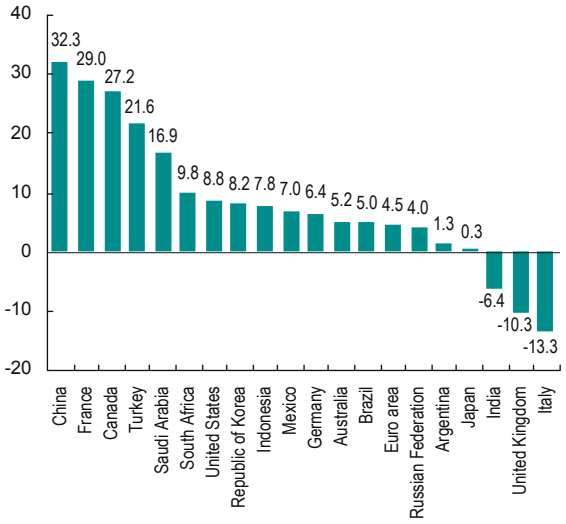
- There was an increase in the debt-ratio for 16 of the 19 G20 countries (the euro zone is the 20th member of G20, but its evolution basically reflects the average of Germany, France, and Italy).

- The largest reductions in corporate debt occurred in the United Kingdom and Italy, which also registered slow GDP growth since 2011. There was also a fall in the nonfinancial corporate debt ratio in India, but much smaller than what happened in the United Kingdom and Italy.

- The largest expansion in corporate debt ratios happened in China, Canada, France, Turkey and Saudi Arabia. The Chinese expansion reflects the leverage of state-owned enterprises. In Canada and France, the change has been to private debt, whereas in Turkey it has been influenced by exchange-rate issues. For Saudi Arabia, the dynamics of the oil market have been the main driver.

- In Argentina and Japan, nonfinancial corporate debt remained almost stable in terms of GDP. In the case of Argentina, this stability reflects exchange problems and financial constraints on private debtors in foreign currency. In the case of Japan, the stable but high debt-ratio comes from the combination of slow growth with negative real interest rates.

FIGURE 1.8 **Change in debt-to-GDP ratio of the non-financial corporate sector, selected G20 economies, 2011–2019**
(Percentage points)



Source: See figure 1.6.

- In the remainder of the G20 economies, the average increase in the debt-GDP ratio of non-financial corporations has been 6.8 percentage points of GDP, indicating that, at least for the corporate sector, there has been no deleveraging since the financial crisis volatility of 2008-10.

The Covid-19 shock will probably raise private non-financial debt ratios around the world. This change is not necessarily bad, since one of the functions of the financial system is precisely to smooth changes in income and expenditure in the face of a massive exogenous shocks like the current pandemic. However, as was noted in *TDR 2019*, if corporate sector borrowing is devoted to the acquisition of financial assets rather than productive physical assets, injecting more liquidity into the economy in a time of crisis, while good for stock markets and possibly giving an indirect boost to growth through resulting wealth effects, is only going to postpone the threat from rising financial fragility to a later date. To what extent leveraged borrowing by corporations could be the Achilles heel of the recovery coming out of the Covid-19 crisis remains an open question (Box 1.2).

BOX 1.2 **The corporate debt bubble: another global financial crisis in the making?**

In the decade since GFC, non-financial corporations have become addicted to cheap debt. According to OECD estimates, since 2008, non-financial corporations worldwide have issued about $1.8 trillion in new bonds each year, a pace roughly double that in the seven years preceding the GFC. At the end of 2019, the outstanding global stock of non-financial corporate bonds was at an all-time high of $13.5 trillion, twice what non-financial corporations owed in 2008 (Çelik et al., 2020). If one adds to this what non-financial corporations owe to banks and other creditors, their indebtedness comes to $75 trillion globally, up from $45 trillion in 2008 (BIS, 2020).

It is not only the volume of debt that gives cause for concern, but also its quality, which appears to have deteriorated markedly since 2008. In 2019, only 30 per cent of the outstanding global stock of non-financial corporate bonds were rated A or above (Çelik et al., 2020). Given that in the first half of 2020, global non-financial corporate bond issuance stood at a record $2 trillion, a 49 per cent increase from the same period in 2019, there are growing concerns that much of this borrowing is sub-standard (S&P, 2020).

How likely is it that corporate debt might explode and cause another global financial crisis, especially given that in the post Covid-19 economy many companies will face heightened financial stress?

As the world economy moves towards a recovery phase, the financial system is likely to confront an array of risks. The two principle risk factors with a bearing on non-financial corporate debt markets are first, the structure of the corporate debt itself, which is likely to deteriorate in a recession and secondly, the continuing, even if overlooked, importance of shadow banking activities in the economy.

Markets in the United States are likely to face the greatest risks. Notwithstanding robust cash positions of major corporations, non-financial corporate bond issuance is dominated by United States corporations and stands at $9.6 trillion, up more than 50 per cent in a decade (S&P, 2020).

In the United States, the corporate sector borrowing binge over the last decade was partly driven by a wave of share buy-backs, a technique used by corporations exploiting quantitative easing programmes and tax advantages and aimed primarily at raising executive bonuses (Lazonick et al., 2020). Also, a decade of low interest rates (and hence, low yield), which stimulated huge and ever-growing demand for safe assets (primarily, bonds). Today, alongside government bonds, investment-grade securities backed by the debt of blue-chip corporations are highly desired by investors and are used as *value-storing assets*. Post-Covid-19, the demand for these types

of securities is unlikely to recede. Thus, despite the heavy overall volume of debt, the segment of high-quality corporate debt in the largest financial market is unlikely to spark a financial crisis.

It is the lower quality debt that does pose a risk of financial fragility. Almost half of the corporate bonds of the United States maturing in the next five years are below investment grade. Corporate debt rated BBB, the lowest investment grade rating, is at an historical peak (S&P 2020). In post-Covid-19 times, these securities will be hard to refinance, while corporations which issued the bonds may face a growing threat of bankruptcy. In an echo of the GFC, the defaults may cascade through the shadow banking system and impact the financial system at large.

The instruments most likely to trigger a wider financial crisis are Collateralized Loan Obligations (CLOs) (Rennison and Smith, 2020). These securities are close relatives of Collateralized Debt Obligations (CDOs), the toxic products that were at the very epicentre of GFC. CLOs are financial products which gather and then structure risky corporate loans into a group of new securities. If CDOs had subprime mortgages as their raw materials, CLOs today have corporate junk bonds as one of their main ingredients. The key principle of a CDO structure is a cascading exposure to default by any of the underlying borrowers. The extent to which banks are exposed to potential CLOs losses is a further source of uncertainty.

Pre-Covid-19, the volume of CLOs had already been rising. In large part this growth was an outcome of post-GFC regulations which aimed to correct the systemic underestimation by banks of the risks in creating yield-bearing securities but ignored the pressures of the ever-growing institutional investor demand on the commercial banks to create investable assets. As a result, the supply of asset-backed securities has failed to keep up with the demand which has, in part, been compensated by new issues of lower quality CLOs. And amid such strong demand, the conditions attached to many loans have become looser.

The onset of the Covid-19 crisis sparked a shock in the credit markets, but aggressive intervention by the Fed supported the market. The main risk post-Covid-19, however, is that corporate downgrades and escalating defaults could start to unravel sections of the CLOs market, in turn prompting a much deeper sell-off that would magnify the existing stresses of the economy. Some of the first cases of such corporate defaults amplified by CLOs were seen already in 2020.[8] While market insiders continue to insist that CLOs have shock absorbers built into them and thus will internalize and contain the risk, the mixture of complexity, leverage and deteriorating credit quality does have strong echoes of the dynamics of the 2008-09 crisis. Even if CLOs will not cause the post-Covid-19 recession, they will amplify the crisis.[9]

The second area of potential systemic risk is also related to the shadow banking system and its institutional evolution since the GFC, which has remained overlooked. In 2008, the wealth management sector, which includes institutional investors, insurance companies, as well as hedge funds and private equity firms, controlled about $98 trillion of assets. After a decade of low interest interests, QE feeding asset inflation and continuing demand pressures, the industry today controls over $180 trillion worth of assets (FSB, 2020). The industry has avoided the close scrutiny of the post-2009 financial regulators, and expanded massively outside of the regulated banking realm, as financiers capitalized on the new opportunities for regulatory arbitrage through risker activities and products. As a result, the potential systemic risk stemming from this largely unregulated area of finance are untested, which raises serious concerns in the post-Covid-19 context.

Traditionally, fund management is not associated with sources of a systemic risk: fund management is a contained activity, where potential losses fall on the funds themselves, but not the asset managers. There was also previously comparatively low reliance on leverage. But as post-2010 regulations hit the traditional banking industry, many bank activities migrated into the investment sector, and the use of risker products and strategies (CLOs, derivatives and leverage) became more widespread. One of the potential pathways to a crisis is a *fund run*: many funds offer investors the opportunity to withdraw their money whenever they want. In times of market stress, this raises the risk of bank run-like situations, forcing funds to sell their assets at fire sale prices, sending overall price level even lower and triggering more capital outflows (Wiggleworth, 2020). While pre-Covid-19, the consensus in the industry has been that due to its fragmented nature, such situations are compartmentalized and do not pose a systemic threat, the post-Covid-19 economy opens up a spectrum of new dangers that span the wider economy and are entirely untested (Haldane, 2014). The opacity of many new products and old strategies (e.g. derivatives) used by the industry today will aggravate a fund run and may well transform a sectoral crisis into a systemic panic.

While the explosion of low-quality non-financial corporate debt has been most pronounced in advanced economies, corporate bond markets have also grown substantially in some larger developing countries since

the GFC rising in total from $380 billion in 2007 to $3.2 trillion in 2017, with Chinese firms accounting for almost two thirds of the total by 2017. Other developing countries, led by Brazil, Chile and Mexico, have seen their stock of non-financial corporate bonds outstanding grow at an annual rate of well above 10 per cent. Emerging market corporate bonds generally receive lower ratings due to higher perceived country risks. And while Chinese bonds are almost all local-currency denominated, around two thirds of other developing corporate bonds are denominated in foreign currency (Lund et al., 2018).

The debt accumulated by the corporate sector of emerging markets during a period of low borrowing costs, when combined with declining currency values, can spark a wave of corporate defaults, putting pressure on bank balance sheets and potentially, transform into a banking and a financial crisis. Such a scenario was played out in the 1997-98 Asian financial crisis and continued after in other emerging markets, such as Brazil, the Russian Federation, Turkey and Argentina. In the post-Covid-19 context, a recession-induced crisis in the peripheral markets, or pressures in core currency markets and, crucially, in China, may well induce a chain of corporate defaults, leading to deteriorating bank balance sheets and ultimately, a financial crisis across the emerging markets, which may spill over to the advanced countries.

Since the onset of the Covid-19 crisis, world financial markets, despite the initial slump, have been sustained by the strong level of state support and continuing investor demand. While these two conditions are not likely to change dramatically in the short-term, stability, as Hyman Minsky repeatedly warned, is destabilizing. The complex financial interconnections between various segments of the global economy, as well as continuing effects of the crisis, may well trigger a combination of events through which historically high levels of corporate debt result in a larger financial crisis. The most immediate areas of concern lie in the areas of the shadow banking system that had been ignored by the post-2010 financial regulations.

Despite each country's idiosyncrasies, two things are common in any analysis of financial consistency. First, the combination of GDP growth and real interest rate is crucial for debt dynamics, private or public. A low real interest rate can make a high-debt ratio manageable even in a slow growth situation as shown by Japan, but it cannot solve the problem by itself. The evidence since the GFC has shown that a low real interest rate is not sufficient to accelerate GDP in many advanced economies. Second, someone's deficit is someone else's surplus and therefore, it is impossible for all agents of the world economy to tighten their belts simultaneously. If the debt-distressed private sector (households or corporations) is forced to run a surplus, then the public sector will have to run a deficit. If the public sector responds with its own belt-tightening that will only further worsen the balance sheet of the private sector, threatening a deflationary spiral. The stabilization of private debt-GDP ratios after the Covid-19 will depend on a compensatory financial move by the government that recovers the economy in a sustainable way.

D. Policy responses to Covid-19

The first economic response of many countries to Covid-19 was to liquify financial markets to stop a credit crunch and deflationary debt spiral. Government emergency funds to support the health response to the pandemic also increased albeit, in many cases, not sufficiently to deal with the magnitude of the problem. This shortcoming created bottlenecks and rationing in health systems, in both developed and developing countries.

What has made this crisis an unprecedented event, however, was the decision by governments to shutdown economic activity in an effort to contain the pandemic, protect overstretched healthcare systems and save lives. This sudden stop triggered automatic spending stabilizers, particularly in the more advanced economies with robust social security systems, but many governments adopted additional discretionary monetary, financial and fiscal initiatives to soften the blow to income, employment, and private balance sheets. The scale of these discretionary actions amounts to massive disaster-relief packages to support firms and families through the lockdown, as well as to aid local administrations in large federations whose revenues fell precipitously.

Based on the IMF and OECD trackers of policy responses to the pandemic (IMF, 2020d; OECD, 2020a), we can divide the policy measures in ten qualitative groups:

- More government funds for healthcare, from either a reallocation or an increase in government spending and credit lines, to raise the capacity of hospitals, produce more medical equipment, pay a bonus wage to medical workers, and search for the best drugs and a vaccine against the disease (Barroy et al., 2020).

- Reduction in interest rate by central banks (Box 1.3). Short-term interest rates went back to zero or close to zero in most advanced economies and there were substantial interest-rate cuts in many developing economies, which can make the effective lower bound of monetary policy a more global phenomenon after Covid-19 (Rogoff, 2020; Lilley and Rogoff, 2020).

- Quantitative easing, defined as an emergency increase in the balance sheets of central banks to avoid a collapse of asset prices in domestic currency. This effort has been stronger in advanced regions, such as the United States, Europe, the United Kingdom and Japan, but many developing economies also created special programmes or facilities to buy government and private bonds during the worst phase of the pandemic (Arslan et al., 2020).

- Regulatory easing, defined as a reduction in the reserve and capital requirements of banks and financial institutions, so as not to increase the credit crunch in a period of higher default rates and capital losses in variable and fixed-income markets. There has also been a relaxation of the necessary provisions for non-performing loans, and many countries adopted debt standstills in domestic currency for firms and individuals most affected by the Covid-19 shock (Borio and Restoy, 2020).

- Tax easing, through deferrals or cancellation of payments, quick refunds and relaxation of audit and compliance rules, both for firms and individuals, to attenuate the loss of income and the emergency demand for credit. There has been an increase in taxes only in handful of countries, usually on high-income individuals and specific superfluous products, but the major trend to fight the pandemic has been to ease direct and indirect tax burdens temporarily, making the treasury function as a "bank" for liquidity-constrained agents (OECD, 2020b).

- Emergency credit lines for the non-financial sector, using public banks or the central bank itself, with the national treasury absorbing part or all of the risk of the operations. Small- and medium-sized enterprise have usually been the main focus of this kind of initiative, but in large federations, emergency lending for regional administrations also became necessary after Covid-19, since subnational treasuries usually cut spending abruptly in response to a sudden and large fall in revenues (Belz and Sheiner, 2020). The same logic applies to the euro zone, but with more nuanced institutional and political aspects, due to the absence of a national treasury and disagreements about a coordinated fiscal strategy (Claeys and Wolff, 2020).

BOX 1.3 Monetary policy and inflation

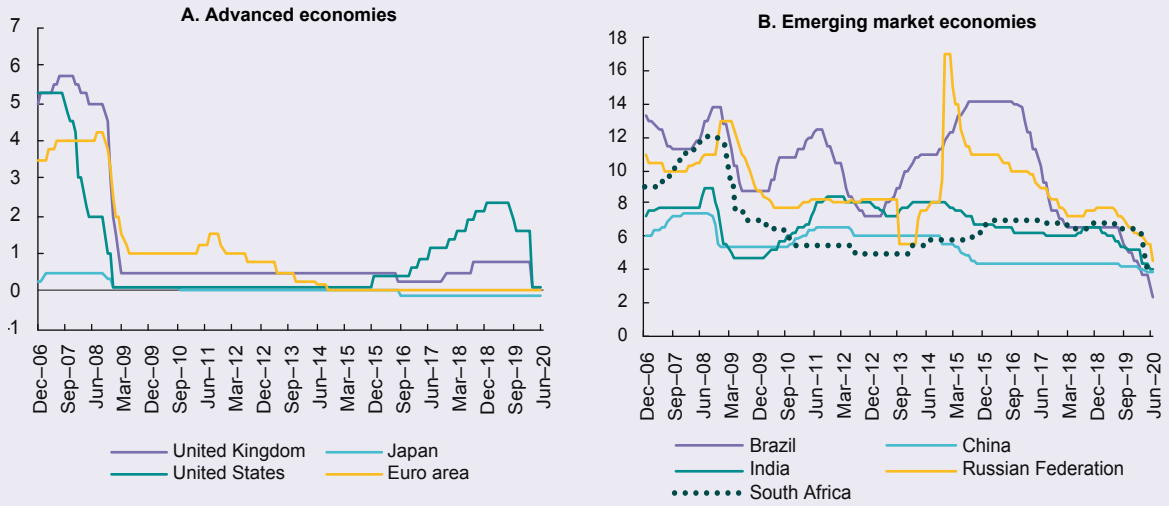
The Covid-19 shock triggered a new round of cuts in central bank policy rates, not only in those advanced economies that had positive rate before the crisis but also in many developing economies, including high-inflation countries such as Argentina and Turkey. The lead came from the United States Federal Reserve, who had already started to cut rates at the end of 2019, before Covid-19, in response to signs of a weakening economy. In the face of the pandemic, the Fed slashed its Fed Funds rate to almost zero, and the Bank of Canada and the Bank of England moved in the same direction. Only where the central bank interest rates were already zero or negative, as in the euro area and Japan, were there no further cuts.

In the largest developing economies, the central-bank interest rate also came down substantially in Brazil, the Russian Federation, India and South Africa, where monetary easing had begun before the pandemic shock. Of the five "BRICs" economies, as of mid-2020, only the People's Bank of China has not cut its interest rate substantially. This idiosyncrasy reflects China's unique financial structure and the fact that consumer prices were accelerating in China until the beginning of 2020. The latter was also happening in India, but it did not stop the Reserve Bank of India from cutting interest rates beginning at the end of 2018, because the acceleration of Indian consumer prices was partly a result of the country returning to normal monetary conditions after the "demonetization" initiative of 2016–2017.

The global reduction of interest rates has been possible because of the expected reduction in inflation worldwide (figure B2). The same pattern happened in 2009, immediately after the GFC, but with a quick temporary

rebound of inflation in 2010 and 2011, which led some countries to raise interest rates and adopt premature fiscal consolidation. At that time, the acceleration of prices proved to be short-lived and the world entered a low inflation period in 2012–2015, in parallel to a deceleration of GDP growth.

FIGURE B.2 **Central bank interest rates, selected economies, December 2006–June 2020**
(Per cent)



Source: UNCTAD secretariat calculations based on Bank of International Settlements (BIS) database.

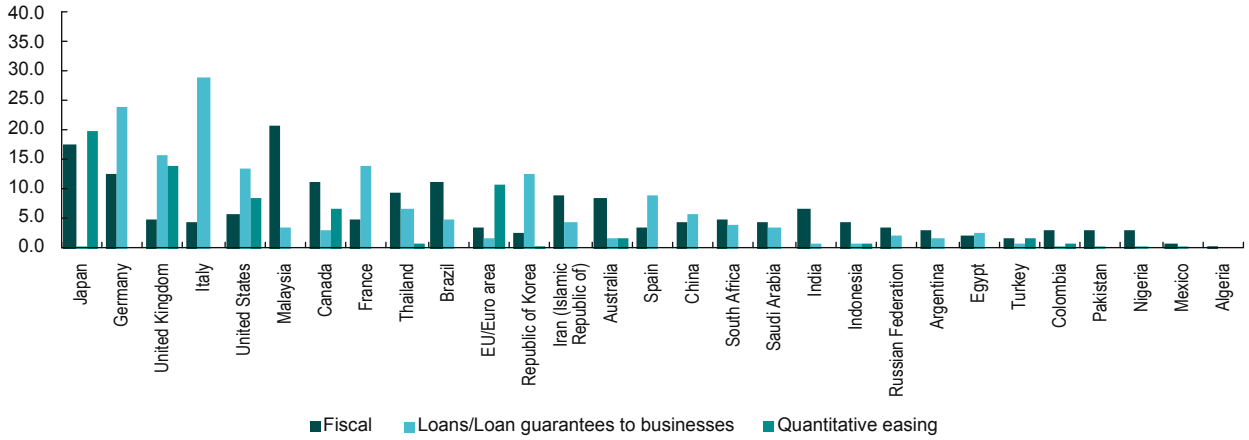
- Rescue or "bail-out" packages to some firms or sectors mostly affected by the sudden stop of the economy, through special long-term credit lines and capital injections. The first recipients of this kind of aid have been airlines and commercial aircraft manufacturers, in both advanced and developing economies. If the crisis gets worse, long-term debt and equity support may be expanded to firms deemed to be essential or strategic, as part of an "industrial policy fit for the 21st Century", as already stated by the German and French Governments before Covid-19 (BMWI and MEF, 2019).

- Emergency cash transfers to formal workers, through a discretionary increase in the length and value of unemployment insurance in many countries, as well as extra government expenditure in short-time programmes that were already in place before the pandemic (Giupponi and Landeis, 2020). The German *Kurzarbeit* is the main example of the latter initiative, in which employers and employees agree to reduce hours and salaries temporarily, while the Government foots part of the bill to attenuate the income loss to workers (Boeri and Bruecker, 2011).

- Emergency cash and non-cash transfers to informal workers and people at risk, through temporary food-distribution and minimum-income programmes to a large part of the population that was out of formal safety nets. Aside the usual disaster-relief transfers of goods and services, some countries adopted massive discretionary cash transfers to low income families in 2020, with very little conditions attached to it. The most common strategy has been to sustain income through a temporary "stimulus check" (as in the United States) or "coronavoucher" to unpaid workers (as in Brazil), with an extra benefit for families with children. This kind of initiative is supposed to be temporary, but its adoption has already triggered discussions about a permanent universal basic income after the Covid-19 shock (Standing, 2020).

- Exchange-rate smoothing through interventions in the spot and derivatives markets for international currency, especially in developing economies, with the support of high international reserves, multilateral emergency credit lines and, in a few cases, swap agreements with central banks of advanced countries (Bahaj and Reis, 2018). Many developing countries reduced their international reserves to attenuate the impact of capital outflows on the international price of their currencies, but the Covid-19 shock has also increased the role of derivative operations to mitigate exchange-rate volatility, together with proposals to include a "hedger-of-last-resort" in the toolkit of multilateral institutions such as the IMF (Yeyati, 2020).

FIGURE 1.9 Magnitude of policy stimulus measures in response to Covid-19 outbreak
(Per cent of GDP)



Source: UNCTAD secretariat calculations based on national sources.
Note: Fiscal estimates are based on fiscal spending and tax stimulus measures. Short-term deferral measures, i.e. tax payments deferred from one quarter or month to the next, are not included in these estimates. Loans/loan guarantees to businesses estimates are based on loan/loan guarantee programmes. Quantitative easing estimates are calculated on the basis of asset-purchase programmes. When provided, the magnitude of the stimulus measures is based on the official estimates from the relevant government authorities. Otherwise, magnitudes are estimated based on UNCTAD secretariat calculations. For the EU/Euro area, fiscal and loan/loan guarantees to businesses measures correspond to the EU-27, while quantitative easing measures correspond to the euro area. All estimates are based on announcements made by relevant government authorities in reaction to Covid-19 outbreak until 30 June 2020.

The actions described above involve many policy instruments covering different time frames making them difficult to integrate in to one composite quantitative response measure. To deal with this difficulty, the policy responses of the main economies of the world can be re-grouped in to three categories: fiscal policy, emergency loans and loan guarantees, and quantitative easing. To get a first sense of the response, we sum up what has been *announced* as of mid-2020, in proportion to the GDP of each country or region (figure 1.9). The estimated total of these announcements is around 13 trillion dollars.

Announced plans do not, of course, always translate into commensurate policy actions. However, it is clear that monetary responses, in the forms of loans and guarantees and/or quantitative easing, have been the preferred response to the Covid-19 shock in advanced economies but that fiscal packages have been significant in a number of cases. Both responses are significantly smaller in developing economies, where fiscal space is constrained and many central banks try to maintain a minimum precautionary level of international reserves to manage a stringent balance-of-payments constraint, however, fiscal packages have been significant in some cases.

It is still too soon to gauge the effective economic response of each country or region to Covid-19, or to separate what is a result of discretionary government decisions and what comes from exogenous support and endogenous mechanisms built into macroeconomic policy rules. However, as of mid-2020, two things seem certain for coming economic policy discussions: this year there will be a deep global recession and a massive global increase in public debt.

E. From disaster-relief to economic reconstruction

Most policy responses to Covid-19 have been concentrated on relief or compensatory aid to firms and families, as well as preparation to deal with new waves of the disease. These measures have surely been necessary to save human lives and avoid an economic recession turning in to a more prolonged depression, but the post-pandemic world will require more than disaster relief and

prophylactic measures to recover from the current shock.

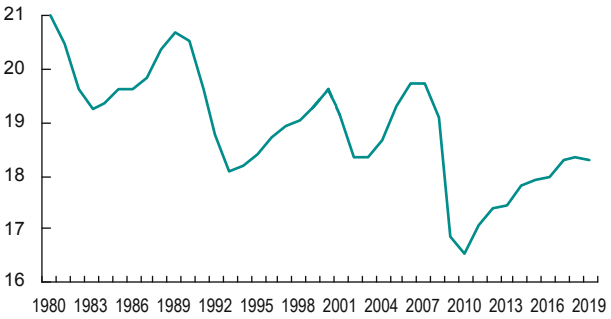
The state of the world economy was far from satisfactory before Covid-19 appeared, as argued in previous UNCTAD reports, and the current health shock has exposed many of the stresses and fragilities that need to be addressed for the global economy to become more resilient and move on to a sustainable economic, social and environmental growth trajectory. Indeed, there seems little doubt that once the bottom of this crisis is reached, the world will not only be trillions of dollars worse off, it will be more unequal, more insecure, and more indebted than it was before. Governments will be more beholden to the vagaries of financial markets, large corporations will be more dominant, and the digital divide will have widened further.

Calls for a rethinking of the basic social contract (a "new deal," or other monikers) have, not surprisingly, grown louder. The *Financial Times* has thrown down the gauntlet to governments in a series of challenging editorials: "Radical reforms — reversing the prevailing policy direction of the last four decades — will need to be put on the table. Governments will have to accept a more active role in the economy. They must see public services as investments rather than liabilities, and look for ways to make labour markets less insecure. Redistribution will again be on the agenda; the privileges of the elderly and wealthy in question. Policies until recently considered eccentric, such as basic income and wealth taxes, will have to be in the mix." (*Financial Times*, 2020:8).

Economic reconstruction after Covid-19 will, above all, require active government policies to reduce income inequality while lowering carbon emissions; large public investment projects to generate jobs and accelerate the transition to a low-carbon energy-efficient economy and structural reforms to transition to new patterns of production and consumption. Developing nations will require access to sufficient and affordable financing and technology, along with more policy space, to make their contribution to a sustainable planet, as they also seek to close the economic and social gaps with advanced nations (*TDR 2019*).

Market forces alone are neither able nor suited to guide economic and social transformations on the scale required, including meeting the Sustainable Development Goals (SDG) by 2030. Indeed, the hyperglobalization era, despite establishing a business-friendly environment, has, in many countries, failed to deliver a fast pace of capital formation, in large part because of the spread to corporate boardrooms of an investment calculus drawn from financial markets (*TDR* 2017). After the financial crisis, investment did recover in advanced economies but not to pre-crisis levels, and was already slowing down or declining as the decade came to an end, with adverse consequences for global growth (figure 1.10). And while the lockdown will produce a welcome reduction in carbon emissions this year, strategies to permanently lower economic growth are neither realistic nor appropriate for most of the world, since they risk freezing current levels of poverty and the global distribution of income and wealth in their currently undesirable state.

FIGURE 1.10 **Private capital formation in G20 developed economies, 1980–2019**
(Per cent of GDP)



Source: UNCTAD secretariat calculations based on United Nations Global Policy Models, and national sources.
Note: G20 developed economies includes the Republic of Korea.

That the recovery to the Covid-19 shock will require increased public investment, along with novel ways to manage fiscal constraints and imbalances, is indisputable. The experience since the GFC has shown that reducing the real interest rate to zero or negative values helps but it is not sufficient to spur market forces to stimulate investment and bring the economy back to full employment, let alone to transform current carbon-heavy patterns of consumption and production. Significant government incentives for targeted investments and innovation combined with strategic planning will be required to accelerate green inclusive growth, including penalties or outright prohibitions on activities with clear negative externalities for social stability and environment preservation. All of this implies a mixture of more active fiscal, labour and industrial policies in the post-Covid-19 world. Policy must aim to recover employment and boost national income, and to shift its distribution, while also changing the underlying production structures.

TDR 2019 showed that a large-scale coordinated investment push – upwards of 2 per cent of WGP and spearheaded by the public sector – to reinvent energy and other carbon-emitting sectors of the economy and radically alter production and consumption patterns was not only necessary but feasible. An investment push on this scale will also need to tackle high levels of income inequality and at the same time, adopt more progressive fiscal arrangements, and directly target social outcomes through employment creation, decent work programmes and expanded social insurance. Recent discussions dubb such a strategy a "Green New Deal" recalling the efforts of the Roosevelt administration in the United States to tackle unemployment and low wages, the predatory nature of finance, infrastructure gaps and regional inequalities, in the context of recovering from the Great Depression. Given the nature of the climate crisis, and now the health crisis, such a programme would, at this moment in history, require a global effort.

Enhanced international cooperation and coordination will be essential if genuinely taboo-breaking measures are to deliver on scale and on time and without themselves generating daunting challenges for future generations. The leading countries and regions of the world, which have more material resources and policy autonomy to implement change in their own economies, will also have to support change in the rest of the world. Coordinating these packages and extending financial support beyond the core will require effective and active multilateral institutions. The existing multilateral architecture has, however, struggled to keep up with the challenges of a hyperglobalized world (see chapter V). Recovery strategies in some advanced and developing countries have included measures to help build resilience on both the health and environmental fronts (Box 1.4), but international cooperation and coordination has been woefully short of what is needed or absent altogether.

The policy space for autonomous recovery and reconstruction policies is much more limited outside the United States, China, Europe and Japan, which only heightens the responsibility these countries and regions should assume in coordinating their economic initiatives and encouraging more progressive change in the rest of the world.

BOX 1.4 Green shoots: The environmental dimension of recovering better

The coronavirus pandemic has brought about a global health catastrophe and widescale economic hardship. Building back better offers the opportunity to establish more equitable, inclusive and resilient growth paths that are also environmentally sustainable. Accordingly, the recovery strategies adopted by governments can initiate the kind of "green transition" promised in Paris in 2015 that would deliver on the target of a maximum 1.5 degrees global mean temperature increase by 2100. To do so, the IPCC estimates that global net carbon dioxide (CO_2) emissions must fall by about 45 per cent by 2030, and reach net zero by 2050.

TDR 2019 showed that a judicious mix of fiscal, incomes and industrial policies could raise wages, investment and growth while reducing carbon emissions. Key is a large-scale public investment drive into clean energy and transport systems, with complementary investments in sustainable food production for the growing global population, as well as for addressing problems of pollution and environmental degradation more generally. Repairing the economic damage from the Covid-19 shock and the planetary damage posed by warming temperatures calls for a bold approach; an estimated additional 2-3 percentage points of global output invested each year over the coming decade (or longer) in such programmes would, given existing multipliers, generate the income and jobs growth required to ensure their financial viability, albeit relying on greater international coordination than is currently the case.

While some governments have already begun to unveil recovery strategies in which the transition to green energy and carbon-neutrality takes a central role, others are still lagging behind. Stated intentions to put environmentally-conscious, green investments at the heart of recovery strategies must translate into "shovel-ready" projects which can be readily scaled-up. In this respect, policymakers are in a much better position than was the case after GFC (Pollin, 2020).

Among the more ambitious proposals to date is the European Union's Green Deal, officially unveiled in January 2020, which sets out policy actions and accompanying financing mechanisms with the objective of achieving a carbon-neutral economy by 2050. The deal envisages actions across various sectors of the economy, including investments in environmentally-friendly technologies, cleaner forms of transport, decarbonization of the energy sector, more energy efficient buildings, and raising global environmental standards. In order to realize these investments, the European Green Deal Investment Plan would mobilize at least €1 trillion over a period of 10

years. This would include €100 billion in investments through the "Just Transition" mechanism- including a fund of €7.5 billion with its own envelope within the European Union budget, to provide financial support to citizens, businesses and regions that are most affected by the transition to a green economy.

In light of the pandemic and its economic fallout, the recovery strategy announced by the European Union at the end of May appears to give a further boost to the transition to a green economy with measures to significantly beef up the funding and financing mechanisms envisaged in the European Green Deal.

The provisions within the recovery strategy relevant to the green transition include: Increasing from €7.5 billion to €40 billion the resources available in the Just Transition fund; reinforcing by €15 billion the European Agricultural Fund for Rural Development in order to provide assistance to rural areas in making the structural changes required in the European Green Deal; directing €91 billion of European Union loans and grants per year towards building renovations that include rooftop solar panels, insulation and renewable heating systems; directing up to €30 billion into clean hydrogen fuel; Tendering 15GW of renewable energy capacity over the next two years which will generate investments of around €25 billion; providing €10 billion of support for renewable projects through loans administered by the European Investment Bank; Mobilizing at least €10 billion for new natural capital and circular economy initiatives through the InvestEU fund; providing additional funding for the "Horizon Europe" research initiative on developing new clean technologies; Delivering €20 billion of European Union grants and guarantees over two years to boost sales of clean vehicles as well as installing 2 million electric and hydrogen charging stations by 2025; targeting investments of €40 billion from the European Union budget to zero-emission trains; and triggering up to €20 billion in investments for sustainable transport infrastructure and clean public transport.

These increases in investments towards the green transition are to be sourced through a new recovery instrument totalling €750 billion called Next Generation EU, which will be financed with new EU debt- as well as targeted increases in the long-term EU budget for 2021 to 2027 worth approximately €1 trillion. This was an important first step but, for reasons discussed in last year's *Report*, the hope that this money would leverage additional private sector funding several times larger was overly optimistic. Public financing options will have to be much more robust.

With regards to the United States, the nature of the recovery strategy to be taken up in the aftermath of the pandemic will depend on the outcome of the election cycle at the end of 2020. The only concrete budgetary proposals offered thus far in terms of greening the post-pandemic recovery have come from members of the Democratic Party including its presidential candidate who has called for $2 trillion in investments in clean energy, jobs and infrastructure over the next four years. These investments would include the updating of four million buildings to meet higher efficiency standards, as well as setting the country's power sector on the path towards becoming carbon pollution-free by 2035. While short on policy detail, the candidate's plan is to be paid for through a combination of stimulus spending and taxes on corporations and the wealthy.

The recovery strategy to be adopted by China in the aftermath of the Covid-19 outbreak, and the role of green investments within this strategy will be largely determined by the outcome of deliberations currently under way in the National People's Congress (NPC) for the country's 14th Five Year Plan (FYP), which is set to be released at the beginning of 2021 and whose remit will be for the period from 2021 to 2025. Among the four priority areas already established for the 14th FYP is that of green development, along with digitalization, further opening of the economy and financial markets, and support for less developed regions.

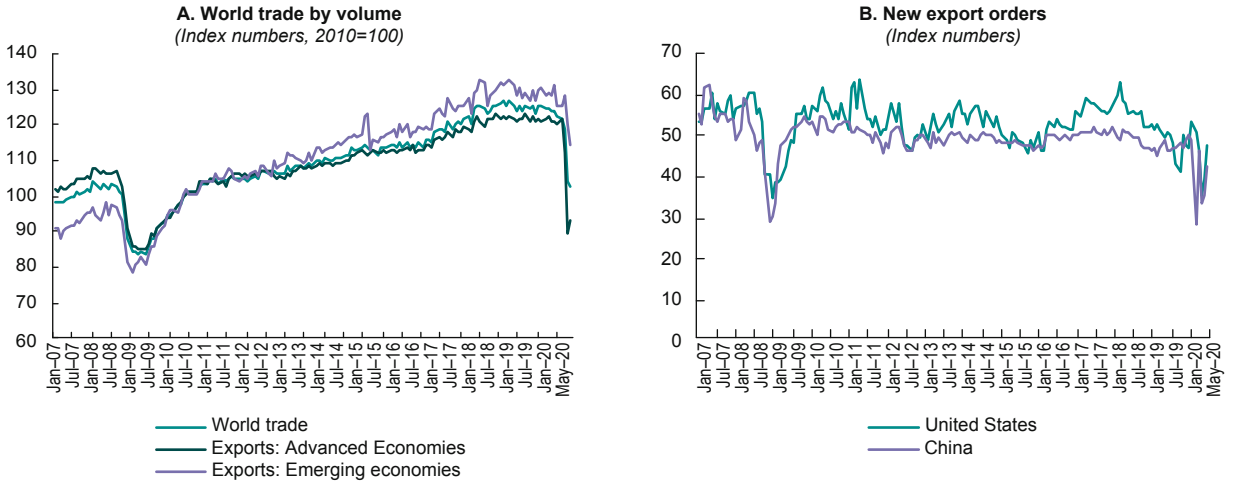
Broadly speaking the plan will guide the direction of industry developments over the five-year timeframe. Of particular relevance to climate policy will be the FYP for electricity power development, as this plan will have an enduring impact on the Chinese energy market. Initial reports from representatives of the NPC involved in the deliberations indicate an increasing focus on investments in clean and renewable energy sources, with suggestions of minimum targets of 300 Gigawatt of new solar capacity and 150 Gigawatt of wind power leading up to 2026 as part of the transformation in China's energy matrix. Moreover, proposals have been tabled to increase non-fossil fuel energy consumption to 25 per cent by 2030 and to 50 per cent by 2050, as well as recommendations to increase support for renewable energy projects and energy storage, the development of green hydrogen production, and the setting up of clean power production and supply chains across the country.

The Government of the Republic of Korea is committed to a post-coronavirus recovery strategy in the form of a "Korean version of the New Deal" based on three pillars of green energy infrastructure, the green energy industry ecosystem, and low-carbon and decentralized energy expansion. It envisages investments of 12.9 trillion won (approximately $10.8 billion) by 2022. Of this total, 5.8 trillion won will go to green energy infrastructure,

with an emphasis on replacing fossil-fuel powered systems with efficient green systems. Another 1.7 trillion won of investment will be allocated to the green energy industry ecosystem to support SME's developing green technologies and to create low-carbon industrial complexes in five cities. Finally, the remaining 5.4 trillion won will be channelled towards low-carbon and decentralized energy expansion which includes investing in R&D for solar, wind and hydrogen infrastructure and energy generation. Through these efforts the Government is looking to triple renewable power output by 2025, with an increase of in solar and wind capacity to 42.7 Gigawatt by 2025 and a target of 54.2 Gigawatt of capacity by 2030.

F. Trade in goods and services

FIGURE 1.11 **World trade by volume and new export orders, selected economies, January 2007–May 2020**



Source: CPB World Trade Monitor, July 2020; United States ISM Manufacturing index; China NBS *PMI Manufacturing Survey*.
Note: New export orders refer to the corresponding Purchasing Managers' Index. A value greater than 50 represents an expansion compared to the previous month, while a value less than 50 represents a contraction, and 50 indicates no change.

The combination of weakening global growth (2.5 per cent in 2019 after averaging 3.0 per cent growth over the preceding 3 years) and persistent trade and technology tensions between the United States and China had already resulted in a negative trend in the volume of goods traded across the globe in 2019. This weakening comes on top of a prolonged slowdown in world trade ever since 2009 due to a generalized shortfall in global demand. Any hopes for a revival of these flows as a result of a supposed pickup in global growth and an easing of trade tensions in 2020 were quickly dashed. The onset and spread of Covid-19 brought about a dramatic fall in international trade flows on a similar scale to that seen during the GFC (figure 1.11A). Data on the volume of world trade from the Netherlands Bureau for Economic Policy Analysis (CPB, 2020) reports a sharp drop of 17.7 per cent in May compared to the same month in 2019, a figure which is similar to the largest single month drop registered during the GFC (19 per cent in January 2009). In a similar vein, the PMI for new export orders for both China and the United States descended to levels only observed previously during the GFC (figure 1.11B).

It is important to remember that variations in the volume of trade flows tend to be more volatile than fluctuations in real output. This is particularly the case during periods of economic crisis. Looking back to the GFC, global output saw a contraction of 1.3 per cent in 2009, while the volume of world trade registered a fall of 12.6 per cent (CPB, 2020). However, the impact of the Covid-19 pandemic on trade volumes goes beyond the sharp contraction in economic growth and demand experienced as a result of the Covid-19 outbreak. It includes the disruptions experienced in transport links and supply chains across the globe as governments introduced severe restrictions in an effort to stem the virus' spread. Such restrictions include the closing down of ports and borders, constraints on air travel (impacting the transport of goods via air freight), as well as delays in customs processing (particularly relevant for the trade in perishable goods). Likewise, the adoption of trade barriers

TABLE 1.2 **Export and import volumes of goods, selected groups and countries, 2018–2020**
(Percentage change over previous year)

Group/country	Volume of exports			Volume of imports		
	2018	2019	2020a	2018	2019	2020a
World	**3.1**	**-0.5**	**-8.8**	**3.8**	**-0.4**	**-8.5**
Developed Countries *of which:*	**2.6**	**0.0**	**-12.0**	**2.5**	**0.1**	**-10.5**
Japan	2.6	-1.6	-9.2	3.1	0.9	-4.4
United States	4.2	-0.5	-12.1	5.2	-0.3	-9.1
Euro area	1.9	-0.2	-13.3	2.2	0.0	-12.2
Developing Countries *of which:*	**3.8**	**-1.1**	**-4.7**	**5.7**	**-1.2**	**-5.6**
China	5.4	0.5	-4.4	6.9	-0.4	-2.0
Asia (excl. China)	3.7	-1.8	-4.4	6.9	-2.3	-6.6
Latin America	3.0	0.5	-8.7	4.8	-1.6	-12.0
Africa and Middle East	1.0	-3.9	-3.1	0.8	-0.2	-2.0

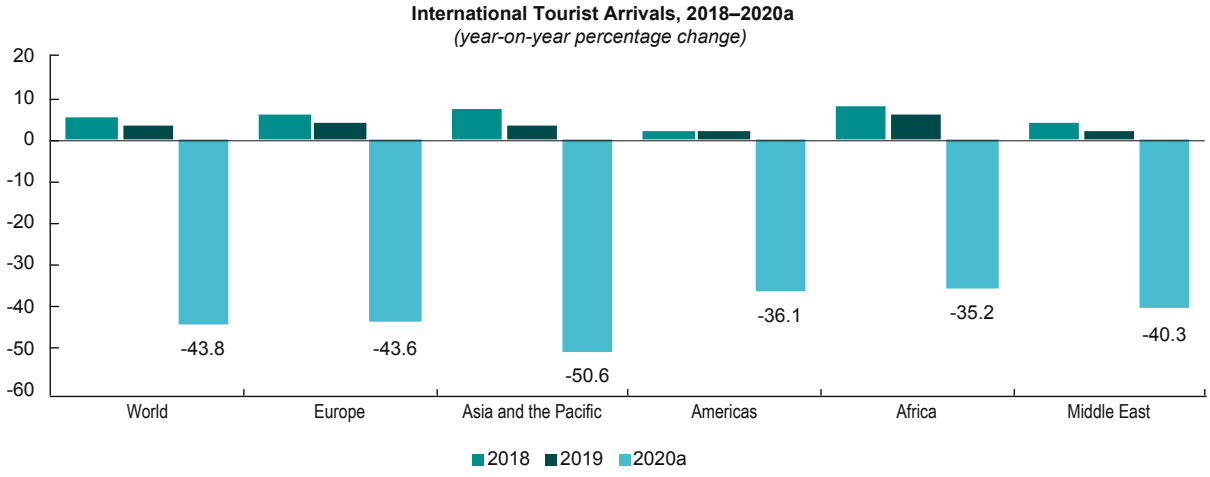
Source: UNCTAD secretariat calculations based on CPB *World Trade Monitor*, July 2020.
Note:
a Percentage change between the average for the period January to May 2020 and January to May 2019.

by numerous countries, particularly concerning export restrictions on medical supplies and food products, has served to further depress trade volumes.

As demonstrated in table 1.2, the decline in trade flows was fairly consistent throughout the different regions and countries of the world. The region exhibiting the largest drop in the volume of its exports was the euro area, which also showed the largest contraction in the volume of imports. For its part, despite being the country first hit by the Covid-19 pandemic, China only saw a relatively moderate decline in its volume of imports.

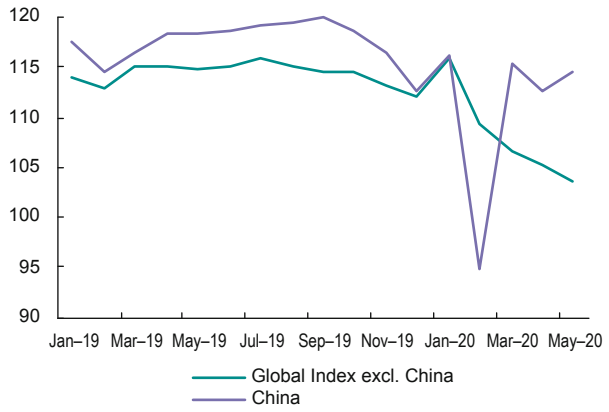
The impact of the Covid-19 outbreak has been particularly pronounced in the trade of services across the globe. The travel and tourism sectors have been especially affected as flights have been grounded, hotels and other tourism-related services have been closed and travel restrictions have been implemented throughout the world. Data from the International Air Transport Association (IATA) shows a collapse in air passenger travel, with a fall of 94 per cent in April compared to the same month a year earlier, representing an unprecedented decline. This contraction comes atop the year-on-year decline of 55 per cent observed in March. Likewise, according to data

FIGURE 1.12 **Annual growth of international tourist arrivals, selected regions, 2018–2020**
(Per cent)



Source: United Nations World Tourism Organization (UNWTO) Barometer June 2020.
Note: ***a*** Provisional data referring only to January–April.

FIGURE 1.13 Seaborne cargo: Shipping container throughput index, January 2019–May 2020
(Index numbers, 2010=100)



Source: Institute of Shipping Economics and Logistics (ISL); Leibniz Institute of Economic Research (RWI).

Note: The Container throughput index of the Leibniz Institute of Economic Research (RWI) and the Institute of Shipping Economics and Logistics (ISL). The index includes the data on container transhipment in 91 international ports, which are continuously collected by the ISL as part of its market observation and account for around 60 per cent of global container transhipment.

from the United Nations World Tourism Organization (UNWTO), international tourism arrivals across the globe fell 44 per cent during the first four months of 2020, with respect to the same period in 2019. The most severe decline was observed in the Asia and Pacific region, where arrivals fell by just over 50 per cent, while other regions of the world all registered substantial drops (figure 1.12). In fact, the decline registered in international tourism flows during this period was the largest on record. According to estimations by the UNWTO, tourist arrivals will suffer a drop of between 58 per cent and 78 per cent in 2020, depending on the duration and severity of travel restrictions and the pace of economic recovery in the second half of the year.

Another important component in the international trade of services is shipping and air freight services, which are closely linked to the trade in goods. The combination of the sudden and severe collapse in global demand for goods and the disruptions to transport links have had a predictably outsized impact on the volume of air and sea cargo. As lockdowns and restrictions on travel and transport links intensified due to the spread of the pandemic, air cargo volumes registered a contraction of 27.7 per cent in April, in year-on-year terms (IATA, 2020). Once again, this is the largest decline on record and even greater than the 23.9 per cent contraction observed in January 2009 in the midst of the GFC. In fact, the cumulated declines in March and April this year reduced the volume of worldwide air cargo back to levels last registered at the end of 2009 (IATA, 2020). Similarly, global port container traffic volume of global sea cargo saw a fall of 6.4 per cent in April compared to the same month in 2019, while that of China saw a year-on-year decline of 16.5 per cent in February (ISL, 2020) (figure 1.13).

The knock-on effect of the collapse in the air passenger industry on air cargo has also been notable as much of the world's cargo is transported on commercial passenger flights. As a result, steep increases in the cost of air freight have been observed, compounding the impact of the shortfall in global demand and transport disruptions of the exports of air freight services.

A rebound in the trade of goods is expected in the second half of this year, commensurate with the recovery in economic activity and the easing of restrictions that have affected transport networks and the productive links in global supply chains. However, the recovery of trade beyond this year is likely to be disrupted by decisions, of both corporations and policymakers, aimed at making supply chains more resilient (Lund et al., 2020). On the other hand, the rebound in the export of services is likely to be more muted, as tourism flows – which make up a significant chunk of services exports – are likely to remain subdued as some travel and border restrictions remain in place and potential travellers continue to exercise caution as they are faced with the lingering prospect of renewed Covid-19 outbreaks.

G. Commodity prices

Having observed relatively moderate declines during the course of 2019, commodity prices registered a sharp drop in the first half of 2020 as the onset and spread of the Covid-19 outbreak brought a severe slowdown in productive activities and trade flows across the globe, as well as widespread restrictions on travel and disruptions to supply chains.

As can be seen from table 1.3, the decline of 7.4 per cent in the aggregate commodity price index in 2019

TABLE 1.3 World primary commodity prices, 2008–2020
(Percentage change over previous year, unless otherwise indicated)

Commodity groups	*2008*	*2009*	*2010*	*2011*	*2012*	*2013*	*2014*	*2015*	*2016*	*2017*	*2018*	*2019*	*2020*[a]
All commodities[b]	33.4	-31.6	24.3	28.6	-3.0	-3.7	-7.9	-36.2	-9.4	17.4	16.0	-7.4	-21.5
Non fuel commodities[c]	22.2	-17.8	26.1	18.9	-12.7	-6.5	-8.0	-18.9	2.3	9.1	-2.2	0.1	-2.3
Non fuel commodities (in SDRs)[c]	18.3	-15.8	27.4	14.9	-10.0	-5.7	-8.0	-11.9	3.0	9.4	-4.2	2.5	-8.1
All food	32.6	-10.4	12.0	24.0	-6.5	-9.6	-0.8	-15.6	3.6	-1.3	-6.5	-2.0	4.9
Food and tropical beverages	31.1	-2.2	11.6	23.6	-9.9	-9.1	3.8	-14.2	2.2	-1.6	-6.6	0.3	4.9
Tropical beverages	19.2	1.1	19.8	31.2	-22.4	-19.8	24.1	-10.3	-3.3	-3.1	-8.5	-5.0	7.1
Food	34.9	-3.2	9.1	21.1	-5.6	-6.0	-1.2	-15.4	4.0	-1.2	-6.1	1.9	4.4
Vegetable oilseeds and oils	35.2	-24.1	13.0	24.8	0.7	-10.5	-9.6	-18.8	7.0	-0.5	-6.2	-7.0	4.8
Agricultural raw materials	8.4	-16.4	37.0	24.5	-19.2	-8.8	-11.8	-13.3	-0.3	5.3	-1.7	-3.9	-6.8
Minerals, ores and metals	19.7	-12.9	33.6	20.5	-6.9	-9.5	-12.8	-17.2	4.6	11.3	1.3	6.2	8.2
Minerals, ores and non-precious metals	17.5	-25.4	39.0	12.2	-16.8	-2.0	-14.6	-24.8	1.4	25.7	2.6	3.4	-8.0
Precious metals	23.4	7.5	27.5	30.8	3.4	-15.8	-11.0	-9.9	7.1	0.4	0.0	8.9	24.1
Fuel commodities	37.9	-38.6	23.1	32.0	-0.5	-1.2	-7.5	-44.4	-17.5	25.9	27.5	-12.6	-36.9
Memo item: Manufactures[d]	4.9	-5.6	1.9	10.3	-2.2	4.0	-1.8	-9.5	-1.1	4.7	4.7	-2.1	

Source: UNCTAD secretariat calculations, based on UNCTAD, Commodity Price Statistics Online; and United Nations Statistics Division (UNSD), Monthly Bulletin of Statistics, various issues.
Note: In current dollars unless otherwise specified.
a Percentage change between the average for the period January to June 2020 and January to June 2019.
b Including fuel commodities and precious metals. Average 2014–2016 weights are used for aggregation.
c Excluding fuel commodities and precious metals. SDRs = special drawing rights.
d Unit value of exports of manufactured goods of developed countries.

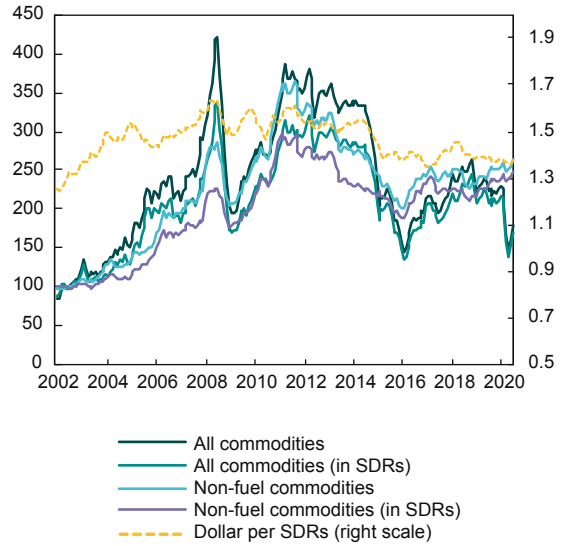
was mainly due to a fairly pronounced drop in fuel prices (12.6 per cent). At that time, major suppliers ramped up production in an effort to capture greater market share in a context of already depressed prices, which offset a slight increase in the price of non-fuel and non-precious metal commodities (0,1 per cent). This downward trend was severely aggravated at the beginning of 2020, with the aggregate index registering a drop of 21.5 per cent during the first six months of the year compared to the same period in 2019.

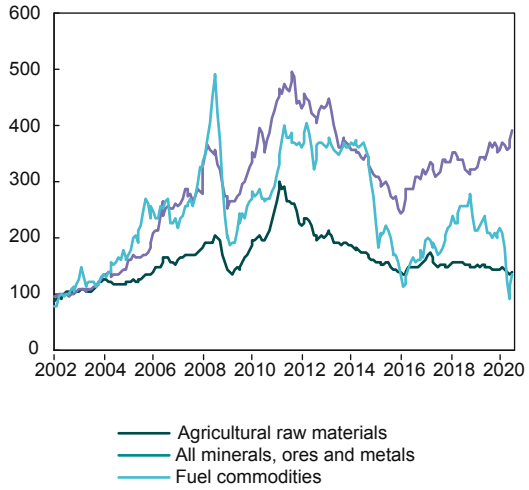
Within this decline in the aggregate index, the trends observed for each commodity group diverged quite significantly (figure 1.14). Those commodities predominantly associated with industrial production activities (industrial metals) as well as travel and transport (fuel) registered substantial drops, while those more directly associated with consumption (foodstuffs) maintained a positive trend. The resilience seen in food prices is in part a reflection of the lower income elasticity of demand for agricultural materials compared to other commodity groups, which typically makes the prices of these goods less sensitive to economic activity.

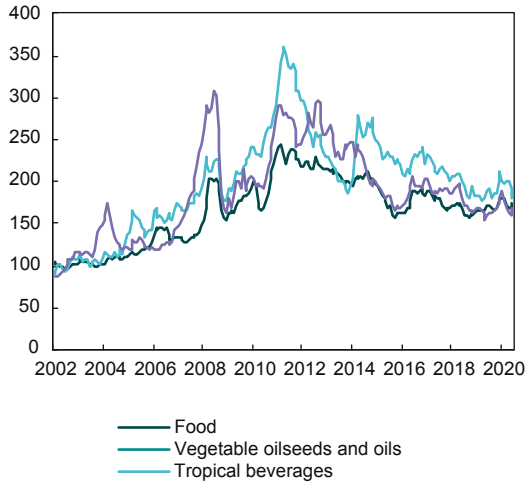
However, the buoyancy observed in food prices amidst the spread of the pandemic is also due to growing concerns regarding food security – particularly for poorer developing nations – due to disruptions in supply chains and transport networks. Also, some countries implemented trade restrictions (including export bans) and increased imports with the intention of stockpiling certain food commodities. Precious metals – seen as a refuge by investors during times of market uncertainty and volatility – also registered significant price gains during the first months of 2020.

The most striking decline in prices was registered for fuel commodities. The emergence of the virus at the beginning of the year and ensuing disruptions to travel, transport and productive activities had already caused a sharp downturn in oil demand and prices by the beginning of March. In turn, the failure of the Organization of the Petroleum Exporting Countries Plus (OPEC+) members to cut production in light of the sudden slump in oil demand precipitated a ratcheting up of oil output by two of the major global oil producers (the Russian Federation and Saudi Arabia), precisely at a time of plunging demand. The resulting collapse in oil prices due to these simultaneous shocks to both supply and demand was unprecedented. The price for United States West Texas Intermediate (WTI) crude oil temporarily dipped into negative territory in April for the first

FIGURE 1.14 **Monthly commodity price indices by commodity group, January 2002–June 2020**
(Index numbers, 2002=100)

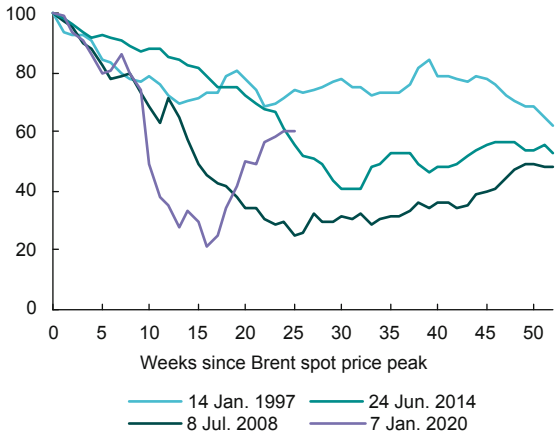






Source: UNCTAD secretariat calculations, based on *UNCTADstat*. For more details on the data sources see: https://unctadstat.unctad.org/wds/TableViewer/tableView.aspx?ReportId=140864.

FIGURE 1.15 **Brent crude spot relative to respective peaks**
(Index numbers, week 0=100)



Source: UNCTAD secretariat calculations based on Refinitiv data.

time on record as holders of WTI derivative contracts severely underestimated the shortfall in oil demand, introducing the prospect of insufficient available storage capacity as WTI contracts neared their expiry date for delivery.

Looking back at the evolution of oil prices during the course of 2020 in a longer term perspective, as we can see from figure 1.15, compared to previous instances of sharp drops in oil prices, the decline observed in 2020 was more severe over a shorter period of time than that seen even at the height of the GFC. The depth of the plunge in oil prices on this occasion reflects the severity of the contraction in oil demand as a result of the pandemic's spread, as well as the compounding impact of the simultaneous supply shock.

An agreement reached in April by OPEC+ members, spearheaded by the Russian Federation and Saudi Arabia, to reduce daily oil production by 10 million barrels a day brought about a strong uptick in oil prices towards the end of the second quarter of the year. As shown in figure 1.15, the pickup in prices as a result of the OPEC+ agreement to cap production levels also proved to be more vigorous than that seen in previous episodes of price drops. Nevertheless, despite the global agreement – the largest ever coordinated cut in production – oil prices seem unlikely to recover to the levels seen prior to the pandemic. Oil demand will depend to a large degree on the pace of economic recovery around the world.

Even in the event of a rapid bounce back in economic activity, the likelihood of ongoing transport disruptions, travel restrictions and continuing reluctance of

potential tourism and business travellers to take trips will restrain the rebound in oil demand. Moreover, on the supply side, limitations to the OPEC+ agreement, such as a reliance on voluntary production cuts in the future depending on prevailing output and price levels, will likely result in global oil supply exceeding the levels envisaged in the agreement. As a result, international oil markets are likely to continue to be over-supplied through the end of 2020. Such an outcome is consistent with previous instances of sudden drops in oil prices, where in the short-term prices remain significantly below their pre-decline levels.

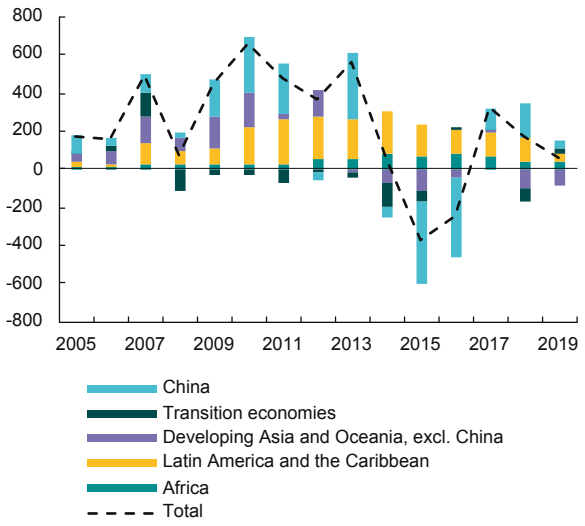
Looking forward, and at commodities more broadly, the trajectory of prices through the end of the year will be primarily determined by the pace of economic recovery, particularly that of China, which accounts for the lion's share of global demand for commodity groups such as industrial metals and agricultural materials. The extent to which disruptions to supply chains and transport can be eased in the second half of the year will also affect prices. Finally, the direction of the dollar, particularly with respect to emerging market currencies, will have a significant impact on commodity prices.

H. Capital flows and exchange rates

There was already a deceleration of net private or non-reserve capital inflows to developing economies before the Covid-19 shock (figure 1.16). Specifically, the total net inflow of capital excluding changes in international reserves and related items fell from $169 billion, in 2018, to $84 billion, in 2019. The fall was even larger if we consider that, in 2017, the total net inflow was $318 billion, but the series show a high volatility, driven mostly by the fluctuations in the net inflow of private capital to China.

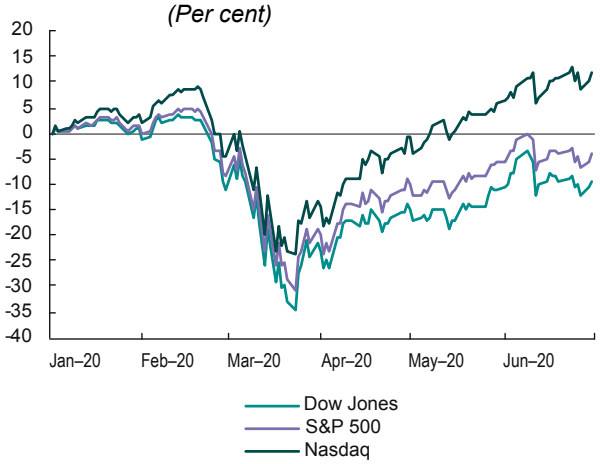
Africa and Latin America and the Caribbean have been net receivers of funds in the last fourteen years. For Latin America, the peak inflow coincided with the peak of the commodity super-cycle of the last decades, in 2011, with a total value of $236 billion. For Africa, the peak inflow was more recent, in 2016, of $82 billion. Considering only last year, there was a substantial fall in net inflows to Latin America, but an increase for Africa, making the two regions register approximately the same number.

FIGURE 1.16 **Net private capital flow by country/group, 2005–2019**
(Billions of current dollars)



Source: UNCTAD secretariat calculations based on IMF, Balance of Payments database.

FIGURE 1.17 **Year-to-date variation in selected United States stock market indices, 1 January 2020–30 June 2020**
(Per cent)

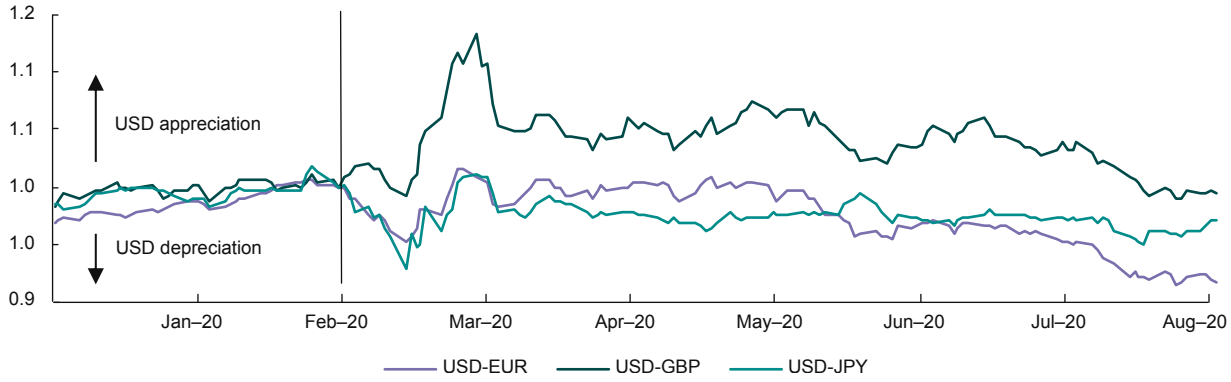


Source: UNCTAD secretariat calculations based on Refinitiv data.

The rest of Asia and Oceania was a net receiver of private capital up to 2012, but since then it has been mostly a capital exporter. A similar pattern holds for the Russian Federation and other transition economies, but with 2008 as the turning point between predominantly net inflows to predominantly net outflows.

The Covid-19 shock led to capital outflows from emerging markets in the first half of the year that were much larger than what happened immediately

FIGURE 1.18 **Exchange rate indices, selected pairs of currencies, 1 January 2020–15 August 2020**
(Index numbers, 26 February 2020=100)



Source: UNCTAD secretariat calculations based on WM/Reuters.

after the GFC or other recent episodes of financial stress. The beginning of lockdown and prospects of a sharp slowdown in world economic activity led investors to flee comparatively risky securities for safe government bonds, especially United States treasuries, causing large outflows of portfolio capital from developing economies. As of mid-2020, the first wave of Covid-19 capital outflows seemed to be receding, as news about the reopening of many economies pushed financial markets into a less pessimistic mood about the pandemic (figure 1.17). Part of this movement reflects the tendency of financial markets to overshoot and undershoot in face of shocks, positive or negative.

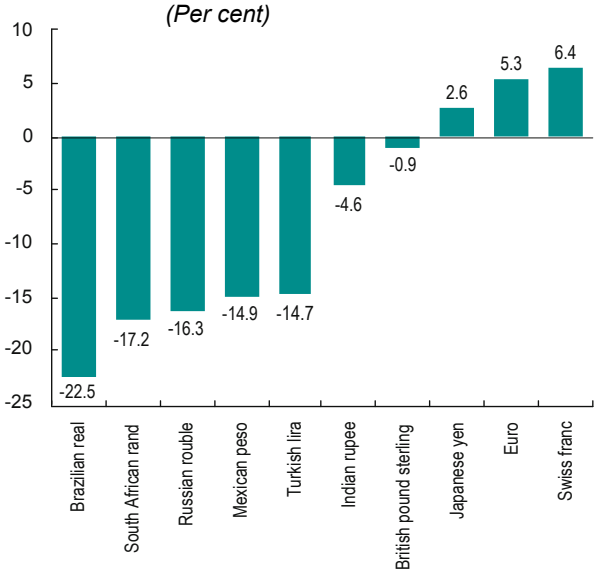
However, given the still high uncertainty about the post-Covid-19 economic recovery and the increasing likelihood of renewed waves of contagion in the second half of 2020 and beginning of 2021, the recovery of many financial indices seemed disconnected from reality as of mid-2020 (IMF, 2020d). In other words, there is probably more overshooting and undershooting to come, which will require proper financial management and multilateral support to developing economies.

The fluctuation in risk perceptions and capital flows had a substantial impact on exchange rates in the first half of 2020. Similarly to what happened after the GFC, the first impact of the pandemic saw the dollar depreciate against the euro and the yen, while at the same time appreciating against emerging-market currencies (Corsetti and Marin, 2020). This initial depreciation was swiftly followed by a strong rebound in the value of the dollar against both the euro and the yen to recover the ground lost since the onset of the pandemic. For its part, as of mid-2020 the USD-GBP exchange rate also seemed to be following a similar pattern of twelve years ago, when the pound sterling initially followed the behaviour of emerging-market currencies, but with less volatility (figure 1.18). The subsequent depreciation of the dollar against all three currencies (euro, yen and pound sterling) from the end of June onwards has brought with it suggestions of a potential end to dollar hegemony and a turning of the tide towards other viable alternatives to replace the dollar as the world's reserve currency. Such calls appear to be premature, with the recent trajectory of the dollar a reflection of deteriorating economic prospects – which would inevitably lead to the Fed maintaining interest rates at low levels – as opposed to a fundamental shift in the international monetary system. The dollar`s trade weighted value is still above its level at the end of 2019 and well above its level in mid-2014 when it began its most recent run.

Considering the main developing economies, as of mid-2020, the hardest-hit currencies were the Brazilian real, the South African rand and the Russian rouble (figure 1.19). The three countries share a high dependency on commodity exports and were already facing challenging macroeconomic imbalances before Covid-19. In the following months, the global Covid-19 recession and the depreciation of emerging-market currencies are likely to increase the current account balances of developing economies.

However, this adjustment alone may not be sufficient to attenuate the liquidity constraint on many middle and low-income countries in foreign currency, since capital flows and synthetic operations in derivative

FIGURE 1.19 **Variation in exchange rate of selected currencies, 1 Jan. 2020–31 Jul. 2020**
(Per cent)



Source: UNCTAD secretariat calculations based on Refinitiv data.

markets usually predominate over trade in goods and services in the determination of exchange rates. Even in the scenario where speculative movements of capital and exchange rates lose momentum, it will still be necessary to adopt proper multilateral financial assistance for developing countries to deal with the foreign-debt service scheduled for 2020-21, while stabilizing their economies.

1. Covid-19, defunct economists and changing mindsets

The Covid-19 shock has demonstrated the need for active economic policy in the face of an emergency. To save lives and preserve income and employment, governments of different political orientations have followed a mixture of Keynesian and monetarist measures, as they did in 2009, as well as more targeted policies on the supply-side. Whether this was the best response to a self-induced economic coma will tax policymakers and commentators for some time to come (Kregel, 2020). However, the post-Covid-19 economic recovery will demand that, unlike after the GFC, policymakers do not abandon a pragmatic approach prematurely under the political pressure of vested economic interests and the intellectual influence of some defunct economists.

Capitalist economies can stay depressed for a long time after a massive recessionary shock. In this context, idle productive resources – both capital and labour – are available to increase output and income, provided there is expected demand to absorb it. Keynes' great insight was to show that under these conditions expected demand can create its own supply. But for this to happen, there must be some source of autonomous demand to pull economic activity from the trough of the recession. This can vary depending on the structural features of each economy but in times when private balance sheets are tightening everywhere, government spending is key.

Drawing the right macroeconomic policy conclusions requires abandoning the comfortable parallel between the government's spending decisions and household economics. Even so, not all countries are in the same position to spend their way out of a crisis. For small open economies that do not issue an international reserve currency, an expansion driven by domestic demand can quickly lead to currency problems if the rest of the world does not expand at the same pace (*TDR 2019*). Economic history is full of balance-of-payments crises, caused by either exogenous adverse shocks to trade and financial flows, or endogenous attempts to accelerate growth in an adverse international situation. Because of this, even though many developing economies would like to recover from the Covid-19 recession in a faster and sustainable way, the viability of expansionary reconstruction policies is not fully theirs to decide. There should be effective policies domestically, but there also should be appropriate international support (see chapter IV).

The situation changes when we move to large open economies that issue an international reserve currency, as is the case of the United States, Europe and Japan, or have a relatively closed financial system and capital account, as is the case of China. In these cases, governments can finance increased public spending by printing money or issuing debt. Functional finance has its limits (*TDR 2019*:48-49) but in any event a domestically led expansion can spur growth and create income – wages, profits and taxes – that help pay for or roll over their own debt issued to fight the recession. When the economy recovers, it can service those debts through future taxation – both of the many and the few whose incomes have risen as a consequence of government spending – or, under some circumstances, through a negotiated write down of the debts themselves. When the real interest rate is low, the fiscal expansion can pay for itself through the short-run multiplier effect of income and its structural positive effect on potential output (De Long and Summers, 2012). The fiscal expansion can be

financed through public debt and still be sustainable, requiring a small or even no increase in the primary surplus of the government in the long run.

More formally, in today's system of inflation targeting adopted in the leading economies of the world, central banks set the short-term interest rate and governments decide how much debt and money they want at the market interest rates. The central bank sets the short end of the yield curve and the market sets long-term interest rates based on, among other things, what it expects the central bank will do. When the economy is depressed, real interest rates tend to turn negative, for both short-term and long-term bonds, signalling that the market does not anticipate an appropriate demand-led recovery. Traditional monetary policy loses power to pull the economy out of the recession. Innovative or radical monetary actions can expand the reach of monetary policy for a while (Box 1.5), but since lending implies that someone is willing to borrow and spend, low interest rates alone are not sufficient to jumpstart economic activity in a deep recession.

For large open economies with a soft balance-of-payments constraint, something more than monetary policy is necessary for economic recovery from a deep recession. Since the 1930s, macroeconomists have understood the need for active fiscal policy, but a more active role of the government in economic reconstruction fell out of fashion in recent decades under the influence of the neoliberal economic mindset. To avoid the mistake of early fiscal consolidation adopted after the GFC, policymakers should adopt a more pragmatic and responsible view of economic policy when the disaster-relief measures taken against Covid-19 come to an end.

The low real interest rates paid on government bonds of advanced economies indicate that there is room for more expansionary and structural fiscal initiatives after Covid-19 that would preserve the environment, reduce inequalities and create a more inclusive society. The reconstruction challenge is more political than material. The leading economies of the world have the financial, technological and productive resources to promote a faster and progressive recovery from the Covid-19 recession.

Such a strategy will probably increase public debt in the short run, while income and employment levels recover. Then, if investment is properly allocated and the gains of the recovery are more equally distributed, productivity will rise and social tensions will fall, creating a virtuous cycle of economic growth and income distribution. In this situation, the eventual excess debt issued to fight the crisis can be dealt with through appropriate fiscal adjustments, since "the boom, not the slump, is the right time for austerity at the Treasury" (Keynes, 1937).

BOX 1.5 What monetary policy can and cannot do?

As of mid-2020, the world was at the "end of the beginning" of another round of quantitative easing. There were massive purchases of financial and non-financial assets by central banks, emergency loan guarantees by national treasuries, voluntary or compulsory debt standstills by private financial institutions and a relaxation of prudential regulations on banks and financial institutions. The actions seem to have averted the worst of the panic in financial markets witnessed in early March, but it is still too soon to declare victory over the adverse financial effects of Covid-19, to say nothing of the effects on ordinary people.

Many firms and individuals will have difficulties to pay their debts and replenish their precautionary savings and, therefore, the emergency financial policies of the first half of 2020 will have to be phased out gradually (Blanchard et al., 2020). In addition to this, the quick return of advanced economies to the effective lower bound of interest rates resurrected discussions and proposals of more aggressive and innovative monetary policies to fight the Covid-19 shock. So far the main initiatives under discussion in the literature are:

- Dual interest rates: the reduction in the remuneration of banks' voluntary reserves at the central bank, to negative values, but maintaining the lending rate at zero or a positive small value (Wren-Lewis, 2016). This would penalize banks for not lending their idle resources, but if the rate on free reserves becomes too negative, it may stimulate physical hoarding of currency rather than lending, which in its turn lead to proposals to end physical money (Rogoff, 2017) .
- Yield curve control: the central bank pegs the long-term interest rate, controlling not only the short-term interest rate, but also the yield curve on government bonds up to a pre-determined maturity, as done in Japan since 2016 and recently announced by the central bank of Australia (Belz and Wessel, 2020).

- Modern jubilee: where possible, push the real interest rate further into negative value to forgive part of the principal of debt and, through this, stimulate firms, individuals and the government to borrow and spend (Barbosa-Filho and Kozul-Wright, 2020).

Even though more can be done by central banks, there are limits to what monetary actions can do in a stagnant economy. At some point, central banks should have the support of the national treasuries, especially when the negative real interest rates lower the risk of more expansionary fiscal initiatives.

J. Regional trends

In North America, UNCTAD expects GDP to fall 5.4 per cent in 2020 and recover 2.8 per cent in 2021. This sharp drop comes mostly from the United States, and despite the large disaster-relief programme announced by the federal Government. Specifically, the sudden increase in unemployment and the difficulty in extending emergency credit lines to low-income families and small-and-medium enterprises are likely to amplify the short-run impact of Covid-19 on its economy. We expect Canada to follow a similar pattern because of its high integration with the United States, but with a slightly higher volatility because of its exposure to the adverse fall in the price of oil after Covid-19.

For Latin America and the Caribbean, we expect a 7.6 per cent GDP contraction in 2020, followed by a recovery of 3.0 per cent in 2021. This forecast reflects the financial problems and slow economic growth of the region before Covid-19, as well as its historically high exposure to variations in commodity prices and international financial conditions. In fact, before the pandemic, economic growth was already slow in Brazil and stalling in Mexico, with challenging fiscal imbalances in both countries. In the case of Argentina, the economy was already in recession in 2019, with high inflation and a severe balance-of-payments constraint, also with challenging fiscal imbalances. Given these adverse initial conditions and the structurally high financial fragility of the region, the economic impact of Covid-19 will probably be more adverse in Latin America and the Caribbean than in any other developing region of the world.

Europe, including the Russian Federation and Turkey, will be the region most affected by the Covid-19 economic shock, with a 7.0 per cent contraction this year and a 3.5 per cent expansion in 2021. Having spread from its initial outbreak in China, Europe quickly became the focal point of the global Covid-19 pandemic during the first quarter of 2020. In the case of France, the impact of the pandemic on the country's services sector, which makes up over three-quarters of France's GDP, has been particularly pronounced with the tourism and hospitality industries being the worst hit. For its part, the economy of the United Kingdom had already shown signs of deceleration over the past two years as uncertainty around the outcome of Brexit negotiations and a generalized slowdown in global demand weighed down on domestic economic activity. Planned negotiations on a trade agreement with the EU and the initiation of a large-scale investment programme have been almost entirely supplanted by the urgencies of the pandemic.

Italy and Spain were the two hardest hit countries in Europe in terms of infection rates, which necessitated the imposition of lockdown measures that were more stringent and prolonged than those in other European countries. Furthermore, the greater limitations in terms of the fiscal space at the governments' disposal severely hamper their capacity to enact adequate economic relief and recovery measures. Conversely, the detrimental impact of the pandemic on the German economy has been more moderate largely thanks to the adoption of large-scale government support programmes which have proved to be far more ambitious in scale than those of other European governments.

In the case of the Russian Federation, the impact of the pandemic is compounded by the decline in the international demand and price of crude oil, provoking a substantial reduction in revenue from oil exports of the Russian Federation, which is exacerbated by a severe tightening in FDI flows to the country. Despite these difficulties, the Russian Federation maintains international reserves which are significantly greater than its international debt obligations, which ensures a certain level of stability to the country's finances and economic prospects going forward. With regards to Turkey, even prior to the pandemic the country's outsized reliance on short-term capital flows and the elevated cost of servicing foreign-currency

denominated debt obligations has represented a continued source of strain and vulnerability for the economy.

In East Asia, UNCTAD baseline scenario is an expansion of 1.0 per cent in 2020, followed by 7.4 per cent growth in 2021. While the East Asian region was the first to be hit by the pandemic, it has also been the first to emerge from the lockdown measures applied to contain its spread. Nevertheless, the impact of the pandemic on global demand will weigh on these countries given that their productive activities are highly integrated into global supply chains and are reliant on external demand from both within and outside the region.

The region's growth pattern is driven mostly by China, where a still relatively high growth rate before the crisis, very interventionist policies to fight the pandemic and a large reconstruction stimulus after the shock are expected to bring the economy quickly back to its pre-Covid-19 trend. In the case of Japan, the economy was already at risk of recession before Covid-19, due to the temporary effect of a tax hike at the end of 2019. The pandemic will therefore cause a recession in Japan, but with a strong recovery in 2021, by Japanese standards, thanks largely to substantial additional budgetary support provided by the Government to both households and businesses. In the case of the Republic of Korea, containment policies which proved to be very effective without causing excessive disruptions to productive activities helped minimize the negative impact of the pandemic on economic growth. Moreover, the close integration of the economy of the Republic of Korea with that of China will help to boost the recovery in the second half of 2020 and into 2021.

UNCTAD expects South Asia and South-East Asia to contract 4.8 per cent and 2.2 per cent, respectively in 2020 and recover 3.9 per cent and 4.3 per cent, respectively in 2021. In the case of India, the baseline scenario is a sharp recession in 2020 as strict lockdown measures to stem the virus' spread brought many productive activities to a halt across the country. Although we expect a rebound in 2021 in line with the growth rates of the Indian economy in recent years, the contraction registered in 2020 is likely to translate into a permanent income loss. The less stringent containment measures implemented by the authorities in Indonesia, coupled with significant support from a strong pickup in government spending will help to moderate the contractionary impact of the pandemic on the Indonesian economy.

Likewise, in Malaysia, the Government's adoption of a series of unprecedently large-scale and broad fiscal stimulus packages will help to prop up demand and to limit the decline in economic activity. In the case of Thailand, the collapse in international passenger arrivals will be extremely harmful to the country's key tourism and hospitality sectors and will result in a sharp recession in 2020. For Viet Nam, the success of the measures applied by the authorities in containing the virus will help to limit the impact on economic activity, allowing the country to maintain positive growth in 2020 and to subsequently return to the high trend-growth rates observed prior to the pandemic.

In West Asia, UNCTAD scenario expects a 4.5 per cent contraction in 2020, followed by a 3.6 per cent expansion in 2021. This pattern mostly reflects the simultaneous shocks from the pandemic and the decline in the demand and price of oil, as well as the subsequent oil production cuts mandated in the OPEC+ agreement, which we analyse in the subsection on commodity prices above. The combination of these factors will result in the sharpest decline in economic activity in the region in several decades, while the drop in fiscal receipts from oil revenues severely limits the capacity of governments to provide fiscal support.

In the case of Saudi Arabia, the Government has tried to balance the need to provide budgetary support to households and firms with the growing pressures on its fiscal accounts. The decision taken in May to implement significant spending cuts and a sharp increase in taxes on consumption goods in an effort to bring down the fiscal deficit will accentuate the magnitude of the fall in GDP in 2020. The expected GDP growth of the region will also be driven by the situation in the Islamic Republic of Iran, where the detrimental impact of the domestic outbreak of the virus coupled with the decline in international crude prices has pushed the ailing economy – which was already suffering the consequences of stringent economic sanctions – into an even deeper and most likely prolonged recession.

UNCTAD also expects Africa to register a recession in 2020 and an expansion in 2021. The contraction will be 3.0 per cent this year, and the expansion 3.5 per cent next year. The decision by numerous governments in Africa to pre-emptively implement containment measures in mid-March to prevent a widespread outbreak of Covid-19 in their countries went a long way in stemming the pandemic in the continent. However, the economic ramifications

have been significant, with the detrimental impact in terms of levels of poverty and income inequality exacerbated by the high proportion of workers in the informal sector and the lack of adequate social safety nets and necessary policy space to enact suitable fiscal stimulus and support.

Given the diversity of the region, this scenario can be broken down in various qualitatively distinct patterns. In the case of Angola, Nigeria and other oil-exporting economies, the contraction in GDP is likely to be particularly pronounced, as these countries suffer the twin shock of the economic fallout from the pandemic as well as the precipitous drop in oil prices. In the case of South Africa, which has been the hardest hit country in the continent in terms of infection rates, slow growth and macroeconomic imbalances before Covid-19 and the application of strict lockdown measures in an effort the contain the virus' spread will translate into a severe recession which will have negative consequences in terms of employment as well as already elevated poverty and inequality levels.

For Ethiopia and Kenya, the impact of the pandemic is compounded by locust swarms which have decimated agricultural production in the two countries. The decline in agricultural output compounds the negative impact on trade, tourism, investment and consumption spending resulting from the economic upheaval brought about by the pandemic and ensuing containment measures. For its part, Rwanda – which has been one of the fastest growing economies in the continent in recent years – will see a significant deceleration in its growth rate in 2020 as the global impact of the pandemic provokes a weakening of demand and prices for Rwanda's main export products – which include agricultural and mining commodities – as well as a drop in FDI flows to the country.

Notes

1 According to the IMF, in international or purchasing-power-parity dollars, WGP was approximately $142 trillion in 2019.

2 Institute of International Finance (IIF). Global Debt Monitor Database, April 2020.

3 Defined, by the IMF, as those economies "that resemble emerging markets with regards to international market access.". See IMF (2020). The Evolution of Public Debt Vulnerabilities in Lower-Income Economies. IMF Policy Paper. Washington, DC.

4 Smith G (2020). Can Africa's wall of Eurobond repayments be dismantled? M&G Investments, January.

5 See e.g. Miyajima K and Shim I (2014). Asset Managers in Emerging Market Economies. BIS Quarterly Review, September.

6 The main benchmark index that tracks dollar-denominated government bonds issued by frontier economies, the J.P. Morgan NEXGEM index, was launched in 2011 with only 17 countries. By April 2020, this had increased to 36 countries (3 HICs, 25 MICs, 2 LICs, 6 transition economies, 4 least developed countries (LDCs) and 2 SIDS).

7 Raddatz C, Schmukler SL and Williams TS (2017). International Asset Allocations and Capital Flows: The Benchmark Effect. Journal of International Economics, vol. 108(C): 413–430.

8 As in the case of the Canadian Cirque de Soleil, whose debts were mostly lower rates leveraged loans.

9 Megan Greene, a senior fellow at Harvard Kennedy School, in Rennison, J. and R. Smith, 2020, "CLOs: ground zero for the next stage of the financial crisis?", Financial Times, 13 May 2020.

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GLOBAL DEMAND AND GROWTH DILEMMAS AFTER COVID-19

II

A. Introduction: a world economy unprepared for a major shock

Despite its tragic human cost, the global capacity of production did not fall substantially because of Covid-19 since the virus did not destroy productive capacity to the extent that cyclical downturns usually do. Nor is it the case that skills have suddenly been made redundant by a profound and permanent technological shift. This may change if the pace of bankruptcies picks up dramatically over the second half of 2020 and if working practices undergo a longer term transformation, but to date there is idle capacity in many sectors and tens of millions of unemployed and underemployed workers across the world. The risk of excessive inflation, were governments to supply the demand so dearly lacking in today's global economy, is as low as it has ever been in a lifetime. In short, there is a window of opportunity to recover better.

But the window will not remain open for long and there is massive uncertainty as to whether governments can muster the political will to make the required choices, ones that should be clear after the failed response to the GFC. Either way policy choices taken today matter for the direction of the economy over the longer term. As soon as the choices are made, one way or another, the dynamics of world economic and financial interactions will drive the outcomes that determine the quality of life for workers and their families, the investment opportunities available for businesses and the environmental health of the entire planet. These dynamics are well-understood and show absolutely no sign of changing absent decisive action. The onus is on the world's Leaders to avoid a lost decade (or worse), and make the choice to revive equitable, sustainable growth.

The Covid-19 shock caused a sudden stop in global supply and demand, with a negative impact on, and feedback from, financial markets, as debt ratios and financial leverage shot up. Given the huge decline in WGP in the first half of this year, the restarting of the global economy will result in a pick-up in many countries, but the path ahead is uncertain (chapter I). Part of the uncertainty comes from the fact that the global pandemic may have altered aggregate supply in significant ways, including the reorganization of supply chains and lasting effects on the labour force and technology. But it mostly comes from the demand side, since households, businesses and governments must take stock of their balance sheets in the face of lost income and accumulated debts before they start spending again. Of crucial importance is how job creation evolves. In the very short term, "disaster-relief" (including income transfers, unemployment insurance, emergency credit) and government spending for goods and services (where lockdowns are eased) will be the abiding influences (Baker et al., 2020).

Critical to determining the shape of any possible recovery over the medium term is the underlying structure of global demand. The world economy was unprepared for any serious shock, let alone one of the nature and scale of Covid-19. This structural uncertainty is an outcome of the GFC – albeit with longer roots in the rules of a hyperglobalized economy – that is not as widely appreciated as it should be.[1] During the last decade, the imbalances exposed by the GFC were not repaired. The debt overhang – private more than public – that brought the world economy to its knees in 2008 is more severe now than it was then. The low employment rates and precarious nature of much work is affecting ever-larger segments of the world's labour force.

Income and wealth inequalities that have hampered economic growth and distorted distributional outcomes everywhere have worsened further, with governments vying with each other to extend tax breaks for corporations and high-wealth individuals

and loosen regulations that favour those at the top (chapter III). The shrinking of the public sector as well as the tendency to fiscal austerity have continued. The weakness of investment in fixed capital and infrastructure – that further constrains capacity, productivity growth and income generation – has persisted. All these trends tend to encourage short-termism and speculative activities that lead to financial fragility.

Mainstream economic analysis has contributed to the lack of preparedness of policymakers by promoting the wrong notion of resilience – one focused on doing business and foreign investors, rather than good jobs and income security – with an attendant narrowing of the aims and objectives of economic policy. Since its founding in the aftermath of the Great Depression, the key principle of macroeconomics has been that effective demand – expected sales of final goods and services – determines income and employment (chapter I). Effective demand includes basic needs and consumption, social services and productive investment that increases productivity.

The world largely abandoned the imperative of demand management with the turn to neoliberal policies in the 1980s and an exclusive focus on measures to boost growth from the supply-side. But especially since the GFC, there has been a greater awareness that inadequate growth of demand can cause a constant downward pressure on productive capacity and supply. Conversely, productivity growth – the main variable supporting capacity and incomes over the longer run – can be triggered by a robust growth of demand and economies of scale that drive specialization (chapter III).

However, there are constraints on a demand-driven growth path. One, and of growing importance, is the natural environment, and the present pandemic is a painful reminder that interdependency has many, sometimes tragic, dimensions. Other pressing constraints of particular relevance to developing countries include lack of access to foreign currency and limited industrial capacity in a world economy that has become more and more dominated by big players. Another possible restraint on the growth of aggregate demand that weighs heavily on the minds of policymakers, in both developed and developing countries, is debt accumulation (chapter I).

The analysis in this chapter starts with a discussion, in section B, of the requirements for robust aggregate demand growth that is both sufficiently fast to underpin development and full employment and is also built around a stable financial system. An evaluation of pre-pandemic demand patterns, which highlight the structural impediments to coping with the shock, provides empirical evidence. Section C covers the post-Covid-19 period. It shows that, unless policies change in favour of demand support and management, a lengthy downturn will ensue. Section D concludes with a template for putting the world economy on a path of stable growth and development.

B. The main sources of demand growth and their financial implications

Global productive capacity remains largely unaffected by the lockdowns; the world's factories have not shut down, nor has it forgotten how to provide services. The challenge of the coming years thus bears some resemblance to the situation after the GFC, namely how to generate a stable stream of income and demand that would reactivate this capacity on a sustained basis. The obvious candidate is public-sector spending which has strong multiplicative effects on aggregate demand while causing minimal leakages to imports and savings. But under the current rules of global governance it is subject to financing constraints, especially in developing economies. These can be loosened but require a favourable international environment (chapter IV). Private demand is larger but for it to be an effective driver of economic growth enough credit has to be channelled to productive activities, a condition that is hard to fulfil under hyperglobalization (*TDR 2019*: chap. II). The remaining option is to seek growth from expanding net exports, a strategy that, even ignoring the fact that all economies cannot pull this feat off simultaneously (a fallacy of composition), will widen global imbalances and heighten global financial instability.

1. State-led demand and fiscal burdens revisited

The prevailing macroeconomic prescriptions of the last four decades insist that fiscal policy lean towards 'austerity' (*TDR 2017*; Ortiz and Cummins, 2019).

That has implied a balanced budget or a surplus,[2] with the expectation that this would help pay off existing debt. But from a macroeconomic perspective other considerations matter. The first has been discussed extensively in earlier *TDRs*: governments can try to reduce deficits or increase surpluses by either cutting expenditures or increasing taxes. But either of these options, or any combination, will compress aggregate demand and lower government revenue as a consequence of weaker economic activity. Government spending is a direct and important component of GDP, while taxation affects net incomes of households and firms, or the final value of goods purchased, thus exerting some influence on consumption and investment. Hence, the fiscal policy options to balance the budget are not independent from their overall effect on the economy, which makes the fiscal balance a moving target (Galbraith, 2009; Godley and Izurieta, 2003; Sawyer, 2017).

Second, what matters for debt sustainability is not the level of debt itself, but its ratio to GDP; in other words, future commitments relative to income. As noted above, GDP can shrink or expand depending on the direction of fiscal policy. An apposite approach is that of a 'self-financing expansion' (chapter IV). This holds that additions to aggregate demand, through government spending and its subsequent multiplier effect, allow the additional spending to be fully paid for from the combination of moderate increases in taxes and stronger economic activity's effect on revenue. Under these circumstances, greater spending can lead to a lower ratio of debt-to-GDP.

Third, the State's ability to service its debt, an inherited stock, is independent of its current fiscal and tax policies. In many instances, debt is serviced simply by being rolling over (Biondi and Boisseau-Sierra, 2017; Turner, 2015). There is no impact on aggregate demand or government revenue leading to more or less spending elsewhere. But when debt is serviced from current revenues, and particularly under fiscal austerity settings, the money is usually obtained by reduced public spending elsewhere (Skidelsky and Fraccaroli, 2017; Jubilee Debt Campaign, 2020), with a detrimental effect on aggregate demand, economic growth and government revenues, potentially leading to a greater debt overhang.

Debt servicing is the one area where the positions of developed and developing countries differ greatly. In developed economies, significant portions of public debt are owned by residents (persons or institutions), although this is changing due to a rapid pace of financial globalization. Servicing the debt in cash implies transfers from the public to the private domestic sectors, which will increase their purchasing power (Godley and McCarthy, 1998). Depending on whether the ultimate recipients are retirees, workers who had invested in government bonds, wealthy individuals or asset managers, there could be some effect on aggregate demand, depending on their spending propensities.

Another characteristic of most developed economies is that, post GFC, interest rates fell near or below zero (Blanchard, 2019; Buchner, 2020; Ragot et al., 2016). Servicing existing debt by acquiring new debt was thus financially advantageous. Finally, to the extent that in most developed economies public debt was mainly denominated in domestic currency, there were no risks associated with a foreign exchange depreciation (Bleaney and Ozkan, 2011; Blessy, 2019). In the United States, and to a lesser extent in other reserve currency countries, balance sheets of domestic institutions would include government debt titles as well as foreign portfolio assets, which appreciate with a dollar devaluation (Akyüz, 2017, 2019). In these privileged situations a depreciation of the currency makes domestic investors richer, and government debt would be more easily acquired.

In short, in developed economies, to the extent that public debt is an asset for the private sector, and the demand for government debt, money and other assets grows with GDP as economic growth raises financial wealth, the government can run a permanent deficit (*TDR 2019*). In other words, expansionary fiscal policy helps reduce debt-to-GDP ratios (Blanchard and Leigh, 2013; Lopez-Gallardo and Reyes-Ortiz, 2011; Stiglitz, 2012; Storm, 2019b; Uxó et al., 2017). Therefore, it is hard to make sense of the contractionary bias of fiscal policy in these economies in recent decades. It is no surprise that their debt-to-GDP ratios shrank so little under austerity or that their growth and employment creation was so disappointing (Skott, 2015; Stiglitz, 2018; Storm, 2017, 2019a; Taylor, 2017).

In developing countries, the constraints and net macroeconomic effects are more complex. Injections of public expenditure have been expansionary in most cases during the post-GFC period (see the analysis of fiscal multipliers in *TDR* 2019). But a significant part of revenues, as well as the value of inherited debt and the cost of servicing or rolling it, can change rapidly if international conditions change. And after annual expenditure plans were announced,

a deficit which might have been expected to shrink after assessment of multiplier effects and revenue feedbacks, could eventually increase due to fluctuations in service repayments to external creditors or shortages of export-related government revenues, enlarging the stock of debt and making future debt repayments more onerous. Hence, policymakers in developing countries tend to be more cautious, and in many instances the ultimate effect of fiscal policy may be doubly averse to growth. Initially, a conservative fiscal position will weaken domestic sources of growth and adversely affect economic and social development (Addison et al., 2018; Martner and Tromben, 2004; Roy and Weeks, 2004; Small et al., 2020). Then, if an external shock actually occurs, the economy is less able to cope with it because of a relatively weaker public sector.

In sum, contractionary fiscal stances represent a dead-end for both developed and developing economies. For the former, for as long as fiscal spending multipliers are greater than one – which is the case except in the extraordinary circumstances of binding supply constraints – there are no macro-financial constraints to an expansionary stance, especially with low or negative interest rates. For the latter, contractionary stances are not a valid option but resolving the financial bottlenecks requires support from global macroeconomic conditions and some degrees of financial insurance, either regional or global. The binding constraint is thus the level of global support to growth and stability, a question of political economy.

2. Growth of demand, private (dis-) savings and financial instability

Insufficient growth of demand because of fiscal austerity or cautious policymaking could in principle be overcome by strong growth of private-sector demand in the form of household spending or business investment. At the end of the day, aggregate demand will be exactly equal to aggregate income, but if ex-ante effective demand is just about the same level as current income there will not be growth. Credit has to be advanced to allow for a pace of growth of income consistent with the overall economic growth target (Cripps and Godley, 1983; Godley and Lavoie, 2007; Goodhart, 1989; Graziani, 2003; Rochon and Bougrine, 2020; Seccareccia, 2003). Mainstream neoclassical approaches miss this crucial fact because of their emphasis on constructing models that rest on the long-term neutrality of money (Weeks, 2012).[3] That credit advances in modern economies are necessary for growth to take place is one essential aspect of the more general observation that a capitalist economy without an exogenous stimulus would remain stagnant (Kalecki, 1962; Patnaik, 1997).

Credit creation inevitably runs counter to the shop-worn prescription of living within one's means. Yet, this prescription is false not only for the public sector where it is usually directed, but for the private sector as well. For the public sector, as argued above, its own demand alters the process of income generation; within limits a deficit-financed expansion can pay for itself. The mechanism is, in the aggregate, the same for the private sector and to a very large degree for the individual private agents. While the ultimate funding sources of consumption and investment are incomes and profits earned, spending decisions are made based on an expectation about future incomes, which are not known with certainty beforehand (Cripps et al., 2011; Robinson, 1979). Next to expectations about income, private agents act on expectations about the evolution of their balance sheets. If their assets appreciate, they may spend more (Costantini and Seccareccia, 2020; Koo, 2008; Turner, 2016; Yellen, 2009).

Thus, a growth strategy that relies solely on private-sector demand must consider the mechanisms of credit creation, wage and profit growth, and asset appreciation. None of these mechanisms are under the direct remit of public policy. Policymakers must find ways of exerting influence on private decisions without directly controlling the outcomes. In the immediate post-war era, and later in a few successful experiences of economic development linked to late industrialization, policy found successful ways to direct credit, to promote industrial development, and to create employment (Marglin and Schor,1992; Shapiro and Taylor, 1990; *TDR 2016*; United Nations, 2017; Wade, 1990). These approaches, by which the public sector oversaw the flow of private-sector credit, income generation and spending underpinned a form of managed capitalism.

However, throughout the last four decades, policies have drifted towards a different paradigm of finance-led globalization (Akyüz, 1995, 2019; Kozul-Wright and Rowthorn, 1998; UNCTAD, 2011). Private-sector spending has taken over as the main engine of growth, making fiscal expansion superfluous. And private credit creation has been left alone to underpin economic expansion and income generation (*TDR 2017, 2018, 2019*).

There are three problems with this approach to the growth of demand, in developing and developed

economies alike: financial instability, income and wealth inequality, and, ironically, sluggish investment in productive capital. The latter results from known channels of influence. Household demand weakens with wage-share compression thus eroding the expectation of investors to generate greater income from supplying goods and services for mass consumption (thereby dampening their 'animal spirits'). Cheap labour becomes a viable substitute for expensive capital equipment. Above all, investment in speculative markets offers more attractive rewards (Ademmer and Jansen, 2018; Fay et al., 2017; Kose et al., 2017; Subramanian and Felman, 2019).

Income and wealth inequality are an immediate effect of policies aimed at promoting investment by supporting net profit accumulation and asset appreciation while weakening labour protections. Inequality is entrenched, both as a cause and as an effect, with financial crises an almost inevitable consequence (Barbosa-Filho, 2019; Galbraith, 2012; Palma, 2019; Perez-Caldentey and Vernengo, 2020; Puyana Mutis, 2019; *TDR 2017*).

Finally, as long as growth needs to rely on credit and the State is removed from actions to control finance and ensure full employment, financial instability and crises become features of capitalist economies (Correa and Vidal, 2012; Kregel, 2007; Minsky, 1986, 2008). But such instabilities and crises are deepened and accelerated by the domestic and international imbalances promoted by a model that rests on increasing private-sector debt. With profit preservation being the linchpin of the model, wage-earners or the public sector bear the cost of crises, and downward pressure on wages suppresses aggregate demand in the subsequent cycle.

3. Net external demand is not a reliable global growth driver

In a fiscally austere world, wherever policymakers discourage private sector dissavings for risk of unleashing financial instability, their economies will inevitably experience current-account surpluses.[4] These external surpluses may be the result of either a fast growth of exports and financial incomes and transfers, or a compression of imports. A first problem arises because, the world economy being a closed system, not all countries can experience net export surpluses. From this observation it follows that the net-export model cannot be 'the' widely recommended recipe. Yet, especially after the fiscal tightening that started in 2010, and along with the calls for trade and financial liberalization that inspired the advancement of broad trade and investment agreements, this model was aggressively promoted (Capaldo, 2015; Kohler and Cripps, 2018).

But all countries did not become net-export winners; instead they faced a global deflationary trap as countries resort to lower unit costs of production through wage suppression – often phrased abstractly as "increased flexibility" – in order to gain external competitiveness. The other important recommendation was to attract foreign investors, as potential carriers of technological advances and market access, by means of favourable tax schemes (*TDR 2019*). Both things together, by eroding the incomes of households and governments, depressed domestic demand. For the world as a whole, it was global demand which weakened significantly – and growth has slowed down in response (Capaldo and Izurieta, 2013; Kohler and Storm, 2016).

Second, a net-export surplus equates to accumulation of external assets, implying accumulation of external liabilities somewhere else. Under most circumstances this is problematic for both debtors and creditors. Indeed, the issue of 'financial' imbalances has been a recurrent topic of global governance since the mid-1980s and most crucially in the early 2000s (Barbosa-Filho et al., 2008; Blecker, 2002; D'Arista, 2007; Eatwell and Taylor, 1999; Godley et al., 2005; Roubini and Seltser, 2005).[5] In almost all cases, however, the debtor economy is hardest hit. And it is increasingly developing countries that are most vulnerable; not only are their external liabilities more expensive to service, their debt is also subject to exchange rate fluctuations. Their external imbalances tend to grow, until they become unsustainable. At that point, the only alternative for the debtor country is demand compression. Such an adjustment has been the standard recipe promoted by the Bretton Woods institutions, justified by the "Monetary Approach to the Balances of Payment" model (Polak, 1957, 1995). Under this model, success presumes a current-account surplus achieved by cutting imports sufficiently quickly. It is a deflationary adjustment, for the single economy and for the world as a whole, especially if the adjusting economy is large.

For the same reasons, the export model is ultimately unsustainable even for the successful exporter. It requires from the deficit countries a double effort

to both maintain a rising demand for the goods and services traded and to honour repayment of debt obligations. It is an effort that cannot last. The constraint on the net exporter lies principally with the limits to the debt-driven growth and financial stability of the net importer.

Third, the pursuit of current-account surpluses as a growth driver is a questionable option especially when promoted in advanced economies. By definition, aiming at external surpluses means relying on the rest of the world to fulfil the additional demand effort for the growth of the economy's income. From a macroeconomic point of view, it is hard to justify the notion that the relatively unsuccessful economies must continue to provide the sources of growth of demand for the relatively successful ones. This issue has lingered for decades, unresolved since the early discussions at Bretton Woods (Godley and Cripps, 1978; Helleiner, 2016; Jomo, 2016; Perez-Caldentey and Vernengo, 2013; Skidelsky, 2005, 2017).

There is possibly one exception where the accumulation of external deficits may be a lesser concern: the United States. As noted early on by Kaldor (1971/1978), and reaffirmed since (d'Arista, 2007; Kregel, 2010b), for as long as the rest of the world is willing to accept a piece of paper in exchange for the goods produced, imbalances can continue to accumulate, global aggregate demand is maintained and, by extension, the net-export model can continue to be promoted. The continuation of such imbalances is further underpinned by two singularities of the economy of the United States. For one, a dollar devaluation makes the residents of the United States comparatively richer as the value of foreign assets increase but the value of the liabilities does not change as happens for most other debtor nations. This would eventually raise the United States' demand and fuel continuing imbalances, as happened during the long period of dollar devaluation from 2002 to the reckoning of the GFC. The other unique characteristic is that the United States earns significantly more from assets held abroad than what foreigners earn for their assets in the United States, thus enabling surpluses in factor payments even if there is a net liability position (Akyüz, 2017; Taylor, 2020).

Fourth, there cannot be much comfort in a net-export model for the relatively successful exporters on the assumption of the continuing deficit accumulation in the United States. One difficulty, clearly exemplified with the GFC (and to a lesser extent the dot-com crash of 2001), is that external imbalances of the United States economy must be matched by internal imbalances of one or more domestic sectors. Thus, a confidence shock to the ability of corporations (the 2001-crash) or households (the GFC) to service their debts can have knock-on effects to the wider economy and, partially at least, to the world economy. The other problem, stressed by Blecker (2013), Rowthorn and Coutts (2004), Taylor (2020) and others, to which Kaldor (1971/1978) also alluded, is that continuing external deficits imply that an increasing proportion of the goods and services consumed is not produced domestically but abroad. In other words, the products of American industry are displaced by outsourcing.[6] This exerts a downward pressure on domestic jobs and hence, an increasing polarization of the economy, between a leading, but confined, high productivity sector and a larger low-productivity sector (chapter III). As long as outsourcing prevails over the objectives of full employment (Kregel, 2010), inequalities will continue to increase.

In sum, export-driven growth is not a feasible growth strategy for the world as a whole, and seldom even for individual countries in a world economy with deepening financial integration. It is a recipe for financial fragility, crises, and rising inequalities. It also depresses global demand in the mid-term and displaces development strategies as relatively less successful economies must earmark increasing portions of their income to service external liabilities while keeping up demand for exporting countries.

4. The configuration of global demand drivers in practice

Table 2.1 maps the main demand drivers by country, using primary historical data.[7] The compilation covers all countries, aggregated to specify the G20 members individually and the rest of the world, grouped by subregions. It is calculated by averaging growth rates over 2018 and 2019 for which full data is available. Figures in the table are not derived from estimates or assumptions but rather result from national accounting decompositions as detailed in the appendix to this chapter.[8]

Column [1] shows rates of growth of national income, a 'memo' item intended to offer a sense of potential contributions to global growth of income. Column [2] shows the gap between the *growth* of domestic demand relative to the *growth* of income.

TABLE 2.1 **The structure of global demand: net injections and net export performance, 2018–2019**
2-year average growth rates (per cent)

	[1] Memo: growth of national income	[2] Net domestic injections to global demand	[3] Net private sector injection	[4] Net government sector injection	[5] Structural change in export performance	[6] Absorbtion of the RoW relative to domestic	[7] Composite index of the structure of demand
Outright global expansionary stances							
China	6.4	0.2	-1.0	1.2	1.2	-0.8	372
Indonesia	5.3	0.2	0.6	-0.4	0.4	-0.4	313
Slow-growing global demand backers							
United States	2.6	0.0	-0.8	0.8	-0.2	0.1	250
Other Africa	2.9	0.3	1.3	-0.9	-0.1	0.0	232
Other European Union	2.2	0.2	0.3	-0.2	-0.8	0.6	210
Other South Asia	0.8	1.9	0.6	1.2	-1.6	0.1	197
Brazil	0.3	0.9	2.4	-1.5	-0.8	0.3	193
United Kingdom	1.0	0.3	0.5	-0.2	-1.3	0.6	189
Russian Federation	0.7	0.5	2.9	-2.4	-0.7	0.6	183
Other South America	-4.8	5.2	5.6	-0.5	-1.4	0.6	178
Saudi Arabia	-0.3	0.1	3.5	-3.4	-1.4	1.2	136
Fast-growing global demand drainers							
India	7.1	-0.5	-1.4	0.9	0.9	-0.7	205
Other East Asia	3.9	-0.1	-0.3	0.2	0.7	-0.5	187
Other Transition Economies	5.0	-0.7	0.9	-1.6	0.6	-0.4	153
North Africa	4.6	-1.0	2.5	-3.5	1.0	-0.1	145
Outright global deflationary stances							
Turkey	3.7	-2.9	-4.4	1.4	0.9	0.6	162
Other Developed Economies	3.6	-0.5	-1.8	1.3	-0.2	0.1	111
Australia	2.7	-1.1	-1.0	0.0	-0.2	0.3	89
Caribbean and Central America	3.9	-1.1	-0.4	-0.6	0.0	0.1	89
Republic of Korea	2.5	-0.7	-1.7	1.0	-0.7	0.7	84
Japan	1.1	-0.2	0.1	-0.3	-0.9	0.5	56
France	1.5	-0.4	-0.5	0.1	-1.0	0.7	56
Canada	2.0	-0.4	-0.3	-0.1	-1.0	0.5	54
South Africa	0.6	-0.1	-1.1	1.0	-1.7	0.8	38
Argentina	-2.5	-0.4	0.8	-1.2	-1.1	0.7	36
Non-European Union Europe	2.6	-1.3	-0.9	-0.4	-1.6	1.0	20
Mexico	0.9	-0.3	-0.8	0.5	-2.0	0.9	19
Italy	0.8	-0.1	0.3	-0.4	-1.7	0.8	15
Germany	1.3	-0.1	0.1	-0.2	-2.2	1.0	-3
Other West Asia	4.7	-3.9	-2.3	-1.7	-2.0	1.6	-12

Source: Values in the table are accounting decompositions from United Nations Secretariat calculations based on the United Nations Global Policy Model.
Note: Net domestic injections are differences between the growth rates of domestic absorption and national income. Private and public sector net injections are their components. Structural change in export performance comprises of three estimates: changes in global export shares, plus changes in terms of import substitution, minus the gap between growth rates of absorption of the Rest of the World and domestic absorption (the latter is noted specifically in column 6, as it indicates the extent to which domestic demand is weaker (-) or stronger (+) than RoW demand. The composite index is an estimate that combines the sources of demand and the degree of structural change in the trade sector, as explained earlier. Individual countries are the G20 original members (where 'other EU' does not include France, Germany or Italy which are already singled out). 'Other' country groups are as follows. Other East Asia includes among others the newly industrialized economies of the region (except Republic of Korea already singled out), Malaysia, Mongolia, Democratic People's Republic of Korea, Singapore, Thailand, The Philippines; Non-European Union Europe includes Albania, Norway, Serbia and Switzerland; Caribbean and Central America includes all countries from the Caribbean and Central America; Other European Union includes Austria, Belgium, Greece, Portugal, Spain, Sweden, and members of the European Union not singled out above; Other West Asia includes all countries of the West Asia region except Saudi Arabia and Turkey which are singled out; North Africa includes Algeria, Egypt, Libya, Morocco, Tunisia; Other Transition Economies includes Georgia, Kazakhstan and Ukraine; Other Developed Economies includes Israel and New Zealand; Other South America icludes all countries from the subcontinent except Argentina and Brazil; Other South Asia includes Afghanistan, Bangladesh, the Islamic Republic of Iran, Pakistan, Sri Lanka; Other Africa includes Angola, the Democratic Republic of the Congo, Kenya, Nigeria and other sub-Saharan African countries excluding South Africa which is singled out.

Positive numbers denote that the economy is, in net terms, injecting growth of demand into the world economy, thus having a net global expansionary effect. Conversely, negative numbers mean that the economy is taken part of the growth of its own income away from the circular flow of global demand, thus having potentially a net global contractionary effect.[9] Columns [3] and [4] show injections (+) or leakages (-) of the private and public sectors, respectively. These are straightforward accounting calculations

that compare the growth of income with the growth of demand of these sectors. By accounting identity, their addition should be exactly equal to the aggregate injection of column [2] (except rounding for this format). Column [5] indicates whether the economy is going through structural change in the export sector. It aggregates three elements: (i) the degree of success in gaining export market shares, (ii) the degree of success in import substitution, after taking away whether (iii) the economy has reduced imports by adjusting domestic demand relative to the pace of world demand. Column [6] shows this third factor explicitly, to highlight whether the *growth* of world demand is faster (+) or slower (-) than the *growth* of domestic absorption. The last column represents an index that condenses information provided in the previous columns regarding the strength and origin of the growth of demand.[10]

While global demand and income grow at the same pace, there are differences at the country or regional levels depending on the sign and strength of their contributions. The table organizes these economies into four groups. The two groups at the top (net injections) exerted, on average during the years 2018 and 2019, a net positive contribution to the growth of global demand, by spending at a faster pace than income, thus providing additional demand and income to the rest of the world. Hence, the net aggregate injection (column [2]) is positive. Meanwhile, the two groups at the bottom (net leakages) had the opposite effect by absorbing such additional growth of demand as an earned income, which is 'saved' (or more specifically transformed in some kind of external financial asset). The accounting is straightforward: the rise of current-account surpluses of these countries (or the reduction of their deficits) make them wealthier in terms of net international investment position. The subsequent classification (on top or bottom for each the net injection or net leakage groups) refers to the strength of domestic absorption relative to the world. 'Fast' or 'slow' in this context is based on the value of column [6], where negative numbers reveal a stronger growth of domestic demand than elsewhere.

More concretely, the two countries in the **top group**, China and Indonesia, are not only injecting net demand into the rest of the world at a faster pace than the income earned (positive values in column [2]), but are also doing it at a faster pace than the growth of world demand (negative values in column [6]). To be clear, these are 'growth-related observations; they can be experiencing, as in the case of China (small) current-account surpluses, but such surpluses were shrinking, thus adding more demand than the income earned. Likewise, in the case of Indonesia, the economy was not adjusting its current-account deficit position but has rather continued to add to the growth of world demand.

The **second group** includes economies which are also injecting net growth of demand to the rest of the world, but their pace is slower than that of their partners (the values in column [6] are positive).

The **third group**, "fast-growing global demand drainers," includes countries where, like in the first group the growth of domestic absorption is relatively faster than the rest of the world, but such absorption does not grow nearly as close as the growth of their own income. In other words, they exhibit a spending pattern by which their growth of income benefits from additional demand emerging from the economies in the first two groups, but they used it not to add to global demand but rather to accumulate external financial assets (or reduce their liabilities).

The **fourth group**, at the bottom, includes economies with global deflationary stances (negative values in column [2]) like in the previous group, but in addition the growth of their own absorption is below the average growth of the rest of the world; they perceive a net benefit to the growth of their income from the additional demand experienced elsewhere without spending it fully, and the overall strength of their aggregate spending is relatively weak.

Table 2.1 shows that the period from the GFC to the Covid-19 shock is characterized by an impaired structure of global demand. The majority of developed countries failed to boost global demand, largely due to their adopting a contractionary fiscal stance. Only a handful of emerging economies were in a position to sustain growth of demand above the global average thanks, in large part, to complementary changes in the structure of their economies.

Global growth by the end of 2019 was faltering. Fragilities affecting public sector finances were not fully resolved but what had become even more alarming was the hazardous growth of private sector debt burdens, particularly in the corporate sector (chapter I; *TDR 2019*). Moreover, it is clear from the table that strong public sector demand in developed economies failed to act as a growth stimulus despite favourable financing conditions, as discussed above.[11] Among these, the failure of surplus economies, which have benefitted from demand generated elsewhere in past years, to boost public sector spending is particularly

noticeable. Rather, the structure of global demand over the last two years hinged mostly on net contributions to growth from developing countries. This is not sustainable; it is precisely in these economies where financial conditions are increasingly more treacherous and governments face increasing pressures resulting in narrower 'policy spaces' (see also *TDR 2014*). In the absence of a radical transformation of the global financial architecture that would allow developing economies to overcome their structural balance of payments constraints, the only road to avert a continuing global slump is a global reflationary push driven and sustained by a robust growth of public sector demand in developed economies.

C. The post-Covid-19 baseline: a 'lost decade'

Once the immediate Covid-19 supply shock is over, the main threats to a full recovery of the world economy stem from two sources. One is the extent of business bankruptcies. While a number of high-profile bankruptcies have already been reported in the second half of 2020 these have not yet amounted to a cascade of cases that would adversely affect the financial sector through defaults and collapsing balance sheets. It is however nearly impossible to make a precise prediction of what might follow, especially where the corporate debt overhang in developed and developing economies is unprecedently high (chapter I). Finance for the corporate sector is entangled in a complex web of institutional connections and, as the 2008 Lehman Brothers collapse showed, their unravelling is only traceable ex-post. But even if for this 'technical' reason the possibility of a systemic financial failure is ruled out, there remains much to be concerned about (see Box 1.2).

The second cause for concern lies with the structure of global demand and income generation underscored in the previous section. If the forces required to launch a global recovery, one that would drive up incomes and restore stability, are not strong enough, or worse still if they run counter to a global demand reflation, the principal victims may not necessarily be large corporations operating worldwide. Instead, small and medium-scale firms, those operating in the informal sectors across developing and, increasingly, developed economies, the self-employed, and ultimately ordinary workers will suffer. Ultimately, the prospects for inclusive economic development will be severely undermined.

1. The starting hypothesis: a shift to fiscal austerity

The review of the structure of global demand offers a framework to make an informed projection of what lies ahead based on current conditions and similar past events. The starting hypothesis is a potential reluctance by policymakers to reinstate a vigorous role for the public sector in sustaining a strong pace of demand growth. This does not ignore the fact, examined in chapter I, that considerable fiscal injections have been part of the policy mix in response to the lockdowns. But nor does this in itself mean a realignment of the economic structure around a strong fiscal stance.

Especially in the developed world, the existing economic structure remains geared to promoting either a debt-dependent, private borrowing-led or an export-led path to growth. Public sector demand injections are seen as a problem, not a solution. Moreover, calls for fiscal austerity have already resurfaced. This is reminiscent of the fiscal response to the GFC, which was initially strongly expansionary but was quickly followed by attempts to withdraw and effectively reverse the direction of fiscal policy. The aim, reducing public sector debt burdens, was at best only partially achieved for the reasons discussed earlier.

But the policy of austerity left scars as measured by a permanent loss of good jobs, decaying infrastructure, and weaker social safety nets. Ten years after, the growth of global demand remained inadequate. Similar results have followed other crises, particularly in the developing world. The most paradigmatic examples are the debt crises that hit Latin American and African economies in the 1980s. Similar cases include the crises in the 1990s, in East Asia, the Russian Federation, and again in Latin America. In all cases, the period after was marked by severe adjustment to the public sector, leading to 'lost decades' in terms of growth and development.

The main difference this time around is of a perverse kind. The size of the acquired public sector debts is unprecedented and across all countries. If austerity emerges as the winning policy option, the consequences are most surely going to be of comparatively gigantic proportions. The underlying

theoretical approaches to this proposition are discussed in chapter IV. The analysis that follows is based on a degree of fiscal austerity consistent with past experience and comparable to the current debt burdens. The resulting 'model scenario' shows its implications.

2. The immediate implications of austerity: protracted unemployment and wage compression

In 'normal times' there could remain some scope for a relatively weak of even mildly contractionary fiscal stance compatible with economic growth triggered by the other main demand drivers: private sector injections or net-export demand. As reviewed above, there are serious limits to these options and the risks of financial instability or global macro-imbalances are not negligible, but those remain open possibilities. However, the post-Covid-19 period cannot, even remotely, be classified as 'normal times'. Besides, even before Covid-19, the structure of global demand was clearly impaired by the absence of a strong and reliable source of growth.

If fiscal policy by next year leans to a net-saving mode (de facto austerity), withdrawing demand from the flow of income, private sector demand is not going to make up the gap, and with few exceptions and with significant risks, nor will net-export demand. Private entrepreneurs tend, in the aggregate, to respond to reliable indications from a dynamic economy, which will not emerge if the public sector prematurely removes support, cuts investment projects, downsizes purchases of goods, outsources services to private contractors and cuts jobs. Household demand injections also rest on secure and reliable sources of income which allow for net-borrowing spending on a structural basis.

A sustained growth of household spending supported by an unrelenting boom in asset markets (stocks and houses) is highly unlikely. The Covid-19 shock and past experiences of credit busts have made the housing sector more cautious, while equity ownership is highly skewed to those at the top who have a lower propensity to consume. A generalized borrowing-led consumption boom will not be on the cards for quite some time, least of all if the public sector withdraws spending. The external demand option will at best work for a handful of economies. Any net-export drive will everywhere drive cost-cutting and weaken aggregate demand.

The information already available suggests that high rates of unemployment are settling in and will last beyond current furlough schemes. The experiences of previous crises are telling. At their peak, unemployment rates hovered around double digits in developed economies. In developing economies, the mechanisms at play for a significant portion of the population are different, especially because of the limited labour protections and unemployment insurance, but overall, the macroeconomic effects are similar: remunerative activities become harder to come by. What is more, the current crisis offers a configuration that is by all standards graver for employment in developing economies: the lockdowns, partial or full, have upset and in some cases destroyed informal networks, while the world economy shock has caused job layoffs in the formal networks, putting even more pressure on the former in the absence of government safety nets.

With high unemployment and subdued economic activity, wage earners are weakened and there is sufficient evidence from earlier cycles of low employment to assert that, in the aggregate, the labour-income share falls and is not reversed until some years later.

Unemployment and wage-share compression have also significant feedback effects on the pace of growth of aggregate demand. Left to themselves, the dynamics from relatively low income and job insecurity, or no job at all, have a deflationary effect on economic activity. Private investment in productive activities is further discouraged, exacerbating tendencies towards more unemployment and lower wage income.

Only an exogenous force can short-circuit the downwards spiral. At times, a lucky exogenous event, such as a discovery of a new resource, a new invention, or a favourable and durable shift in critical prices can be of help. But even then, a sustained support in the form of strong public sector injections would be necessary to overcome a downwards trend. Ruling that out, the configuration of initial assumptions for the scenario, beyond specificities of each economy, can be simply stated: fiscal austerity with negative effect on aggregate demand growth, high levels of unemployment, and low wage income.

3. The macroeconomic outcomes of a protracted slowdown post-pandemic

What follows is a hypothetical but plausible macroeconomic scenario for the years until 2030. It

takes the year 2020 as given and the year 2021 as an approximate estimate of the given conditions, as laid out in chapter I.[12] These estimates as well as the projections to 2030 are generated using the United Nations Global Policy Model (GPM), a stock-flow model of the world economy disaggregated to single out the country members of the G20 and 10 other groups covering all countries. Results are shown by country groups, based on the orientation of external demand, given the discussion in section B.[13]

The main characteristics of the scenario are shown in table 2.2. It assumes a degree of fiscal austerity, especially hitting early on, from 2021 to 2023, further assuming that for the rest of the decade the strength of government injections will be subdued, with the aim of reducing the public debt burden.[14]

The expected medium-term growth performance in this scenario, for the world as a whole and most economies individually, show a noticeable slowdown compared to the past decade.[15] On average, growth rates will be one third below those experienced during the post-GFC, which were in turn more than one-third below those experienced before the GFC. Accordingly, most economies will witness not only disappointing improvements in welfare, income, productive capacity, and employment, but face continuous threats and vulnerabilities as financial balances do not improve to the extent that is necessary to avert financial risks and shocks. A finer but

TABLE 2.2 **The 'lost decade' scenario: selected indicators, 2022–2030**
(Per cent), unless stated otherwise

	World economy	*Developed: current account deficit economies*	*Developed: current account surplus economies*	*Emerging: current account deficit economies*	*Emerging: net energy exporting economies*	*Emerging: current account surplus economies*
GDP growth:						
average 2010–2019	3.1	2.2	1.7	3.8	2.7	7.1
average 2022–2030	2.0	1.0	0.9	2.3	1.9	4.3
at year 2022	2.4	1.5	1.3	2.7	2.4	4.9
average 2020–2021	-0.1	-1.4	-1.3	-1.1	-0.4	4.1
Private investment growth:						
average 2010–2019	4.7	4.6	3.1	4.8	2.6	6.8
average 2022–2030	3.8	2.0	2.1	2.3	2.8	5.9
Government spending growth:						
average 2010–2019	2.9	0.6	1.0	3.4	2.4	7.8
average 2022–2030	1.2	-0.1	-0.2	2.1	1.5	2.3
average 2021–2023	-0.2	-1.2	-1.6	1.5	0.4	0.3
Government-debt-to-GDP ratio:						
at year 2021	89.6	119.7	123.4	84.5	56.8	65.8
at year 2030	91.8	139.6	128.7	105.2	67.8	48.1
Rate of unemployment:						
average 2010–2019	5.1	6.1	7.5	6.2	5.7	2.6
average 2022–2030	6.9	9.1	9.0	9.0	7.0	3.5
average 2021–2023	7.8	11.3	10.4	10.0	7.9	4.3
Share of labour income:						
average 2010–2019	53.0	55.9	55.0	49.6	48.3	55.1
average 2022–2030	49.8	51.1	51.5	45.0	44.4	54.2
Current account [per cent of GDP]:						
average 2022–2030	0.0	-2.9	4.0	-2.5	-1.0	0.6
at year 2019	0.0	-2.8	2.6	-1.6	-0.4	1.7
at year 2030	0.0	-3.3	4.3	-2.2	-0.4	0.4

Source: see table 2.1.
Note: Underlying values are constant USD at market rates, base 2015. Country group aggregates are weighted by each country's GDP in constant USD market values (or the labour force for unemployemnt rates). Growth rates are expressed in per cent terms. Government debt ratios represent gross public debt as per cent of GDP. Unemployment rates are percent of the unemployed over the labour force. Labour income shares are in percent of national income. Current account (CA) deficit developed economies include Australia, Canada, the United States and the United Kingdom. CA surplus developed economies include France, Germany, Italy, Japan, Republic of Korea (which in the GPM structure shows characteristics of developed economies) and the GPM groups 'other Eurozone', and 'other developed'. CA deficit emerging economies include Argentina, Brazil, India, Indonesia, Mexico, Turkey, South Africa and the 'Caribbean and Central America'. CA surplus emerging economies include China and the group of 'Other East Asia'. Emerging energy exporters include the Russian Federation, Saudi Arabia, 'North Africa', 'Other Africa', 'Other Transition Economies', 'Other South America', 'Other South Asia', and 'Other West Asia'. For full definitions of the 'other' country groups, see Table 2.1.

equally important observation should be made about the growth rate expected in 2022. For the world as a whole and for each group, with the caveat of emerging surplus economies, the 2022-growth rate is noticeably weaker than the average of the post-GFC.

In normal recoveries after a sharp exogenous contraction, an economy should experience extraordinarily rapid growth during the immediate years following the shock. Only such hypothetical rapid growth generates sufficient momentum to help realign the economy with its trend and, more importantly, to help clear financial imbalances caused during the early shock, thus restoring macroeconomic resilience. However, because of the (assumed) rapid shift to fiscal austerity, economies will remain treading water for two years after the Covid-19 shock. It is plausible that the resulting fragilities at that point would yield a double-dip recession. But this was not specifically modelled as it would require additional assumptions about a possible but unknown unwinding in asset markets.

Except for the economies grouped in the last two columns of table 2.2, growth of private fixed capital formation in the scenario is disappointingly weak. This reaction is entirely expected given the slow growth of output (the 'accelerator' effect), together with the combined characteristics of fiscal austerity, unemployment and relatively lower household wage income. Investment in this projection will be considerably weaker than in the post-GFC period, which was already sufficiently sluggish as to exert a dangerous pressure downwards on productivity (chapter III). From national accounting logic, surplus advanced economies exhibit weak growth patterns of domestic demand, and that includes fixed capital investment. This is confirmed in the scenario, also given that the wage shares have continued to decline, making capital investment comparatively more expensive.

Investment growth by the deficit economies, both developed and emerging would appear to be comparatively lower vis-à-vis their own past. This outcome highlights the increasingly binding constraint that is experienced by economies which had in the past succeeded in maintaining a borrowing-led (private or public) growth strategy. For deficit developed economies, this may reflect the fact that household sector deleveraging in the context of austerity, unemployment and low wage-earnings may be setting in, despite the fact that such advanced economies could afford the creation of liquidity to underpin a consumption boom. For deficit emerging economies, meanwhile, weak investment follows from both the patterns of de-industrialization and a pressing balance-of-payments constraint (chapter IV).

By contrast, the relatively better performance of private investment by emerging energy exporters mostly reflects the weak and volatile patterns during the post-GFC, due to swings in prices and supply of energy.[16] Finally, growth of private investment by the groups in the last column, given the weight of China in the aggregate figure, is on the one hand, significantly stronger than in the other groups. On the other hand, the pace of growth is slower than in the previous decade, reflecting an explicit policy choice.

Data on growth of government spending shown in table 2.2 partly reflect the assumptions discussed above and partly the endogenous mechanisms at play, which exert a continuing downward pressure on government spending when revenues are also low due to weak growth, and debt burdens remain stubbornly high.

The most apparent figures in table 2.2 are the *average* negative (even if marginally) rates of growth of public sector expenditure in developed economies with either current-account deficit or surplus. On reflection, though, the difference in percentage points of growth of spending between the projection period and the post-GFC is smaller than the differences of aggregate growth of income between the two periods. What is worth highlighting here is the sharp contraction of government spending between 2021 and 2023, when fiscal austerity is assumed to gain policy favour. The estimated contractions are not out of the realm of observable policy reactions, given the size of the fiscal stimuli enacted during 2020 and given the strikingly high debt burdens. While these negative numbers should not, in this context be surprising, it is the overall macroeconomic effects and the implications for jobs and wage incomes that matters. What is more, it should be noted that, as indicated in the table, despite sustained austerity, public debt burdens do not fall, for the reasons discussed in chapter IV.

In emerging economies, meanwhile, the pace of deceleration of government spending is also apparent, though not nearly as aggressively damaging to economic growth performance as in the developed economies. The government spending adjustment is, in these cases, partly a reflection of concern with high debt burdens (which even if significantly lower

than those of developed economies, are generally more onerous because of high, and often external, debt servicing costs). But in addition, especially in situations of slow growth of global demand, developing economies tend to compete in advertising well-behaved fiscal balances to attract foreign investment.

In the context of this scenario, developing countries have much to lose. They need fast rates of growth of government services and infrastructure provision in order to underpin robust development strategies. Meanwhile government activities also tend to support domestic private sector investment and rising consumption and welfare per capita through improved job conditions. But the low rates of growth of spending in this scenario, below those of the post-GFC which were low already, are not going to help. Furthermore, debt burdens are high and will keep rising because of the weak growth performance. Finally, the apparently more stringent deceleration of government spending by the emerging surplus economies (the last column), reflects a strategy aimed at encouraging more private investment in the exporting units, in 'other East Asia', and a shift to domestic consumption in the case of China. As these economies did not experience a severe growth collapse due to the Covid-19 shock, they enjoy relatively more policy space to design their demand-led policy strategies.

The very high rates of unemployment in almost all economies are alarming and should be a cause for concern. Rates during the years 2021-2023 are partly exogenously imposed as assumptions based on available information and various econometric estimates derived from shocks to employment during earlier crises. But they also reflect the endogenous response to the patterns discussed above. Rates of unemployment will remain high, mostly due to the patently weak growth of economic activity, low rates of investment and, for developing economies, the tendency towards de-industrialization. No supposition made in this scenario suggests that there will be an emphasis on supporting job creation. Recent history confirms policymakers concerned with high unemployment resort to supply-side measures.

As discussed above and in previous *TDRs*, policies to promote investment, job creation and economic activity which are centred on profit protection, tax rebates and subsidies are ineffective for that purpose. Together with the promotion of export-driven strategies to generate demand, they drag wage income downwards. What is more, the expectation of success of an export-driven revival of growth, to the extent that is spread worldwide, triggers competition that tends to compress wages on a global scale. The model projection summarized in table 2.2 corroborates this fact. The general tendency in most countries, with few exceptions, is to keep wage demands low while protecting profits, aiming at gaining a competitive edge in world markets and attracting foreign investment. In this scenario, the wage share of developed economies will eventually approach the levels of the emerging economies a decade earlier, while those of emerging economies are successively lower.

Finally, the scenario offers a glimpse at the expected current-account performance of these groups. External positions shown in table 2.2 suggests that past trends will continue, resulting partly from the fact that while almost all strategies aim at gaining export market shares, only those with better starting conditions tend to succeed (again, except for the economies in the last column which exhibit mostly the changing structure of China). Yet, it is worth noticing that the improvements of current-account surpluses for some, and the corresponding deteriorations of current-account deficits for the others, is relatively, and predictably, small during the course of the decade-long scenario. In a world economy characterized by sluggish growth of global economic activity, the scope for making gains and losses through the external sector is limited by weak growth of overall aggregate demand in all partners and more specifically by the tendency to compress wage income as the race to the bottom gathers pace (*TDR 2017*).

In sum, the projected scenario foreshadows an unwelcome combination of patterns, affecting income growth, economic activity, employment and overall economic development, welfare and industrialization. It rests on a few assumptions which are entirely plausible given current and past experiences, and considering the conditions left by the Covid-19 shock on the state of employment, income generation and finances of the public and private sectors. What is more, such assumptions are entirely consistent with the configuration of global demand drivers discussed in section B. Its main lessons however lie not in the assumptions, but in the implications for the world economy. Going forward, the question is what options remain if governments choose to change course, as discussed in the next section.

D. A growth revival scenario to avert a lost decade: policies and outcomes

A lost decade for the global economy – or rather *another* lost decade – is a plausible outcome. The scenario described above is drawn from current conditions and the tendencies fortified through decades of *laissez-faire* policy and, in particular, an unjustifiable resistance to proactive fiscal policy. But a lost decade is not inevitable. This section outlines the central elements for a policy reversal that could help recovering robustly from the crisis and achieve the SDGs.

1. The indispensable strong push for growth

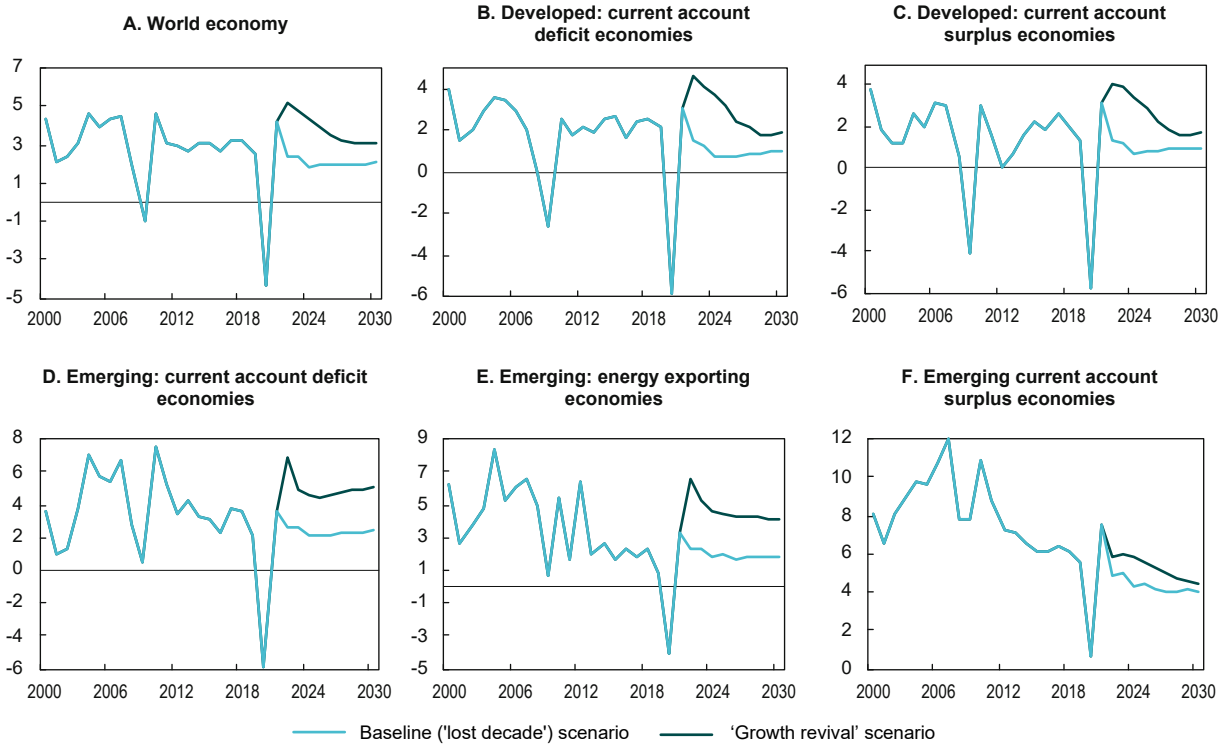
Any sustainable global macroeconomic strategy must achieve a combination of mid-term objectives: robust economic growth, industrialization and development, inclusiveness, employment, financial stability and, importantly climate change mitigation. Together these can determine the macroeconomics of a well-functioning global economy. However, some concerns require immediate policy attention.

The policy approach of the last decade, as documented above, would yield a combination of low rates of growth and high rates of unemployment that would bring about serious systemic risks, both economic and political. The priority for economic policy must be ensuring a real recovery of economic expansion that puts people back to work and restores income growth, while also ensuring that the financial imbalances left by the Covid-19 shock are repaired.

It is not too late yet for an effective stimulus to global demand. As long as productive capacity remains in place, workers have not lost skills or left the labour force and creditworthiness remains robust, a globally coordinated effort to spur demand has a real chance of restoring growth.

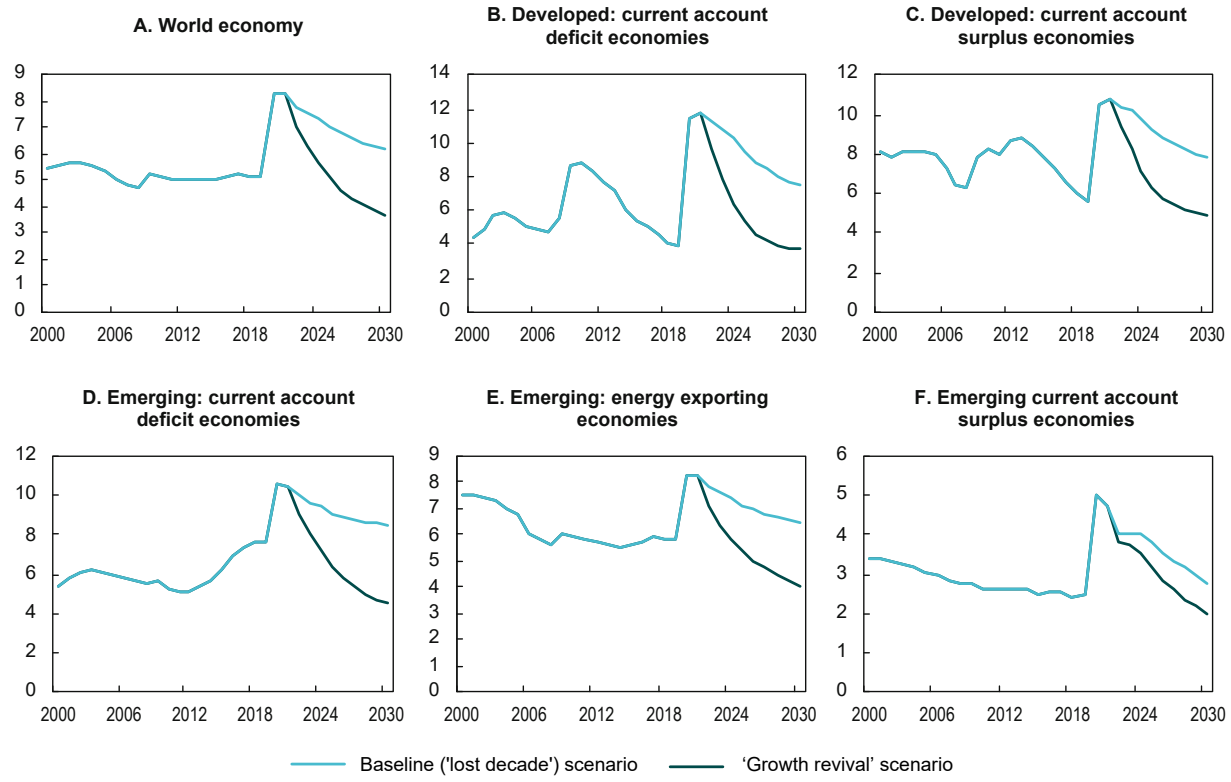
With the private sector everywhere in 'wait and see' mode, the initiative simply must come from the public sector. If the public sector also waits to stimulate demand or, worse, cuts spending, the window for a growth recovery will close fast, carrying

FIGURE 2.1 **Rate of growth of GDP, 2000–2030**
(Per cent)


A. World economy
B. Developed: current account deficit economies
C. Developed: current account surplus economies
D. Emerging: current account deficit economies
E. Emerging: energy exporting economies
F. Emerging current account surplus economies
Baseline ('lost decade') scenario
'Growth revival' scenario

Source: see table 2.1.

FIGURE 2.2 **Unemployment rates, 2000–2030**
(Per cent)



Source: see table 2.1.

with it the risk of exploding debts, and opening the window further to an austerity mindset. Injections of public-sector demand into the economic system can boost incomes across the economy thanks to high multipliers. Only a strong fiscal expansion can bring unemployment down quickly enough to avoid permanently damaging workers, and it can only wind down carefully once the private sector is able to pick-up demand.

The growth performance of an appropriate strategy, termed *growth revival*, compared to the *lost decade* baseline is illustrated in figure 2.1. Model projections in figure 2.2 highlight the reduction of unemployment that would follow.

The scenario's peak growth, projected in 2022, is by no means high compared to the past two decades but it does contrast favourably with the incomplete recovery projected in 2021 (which, highlighted in table 2.2, yielded nil or disappointingly low cumulative growth by end-2021). In other words, the projected growth in 2022 is both needed and is entirely achievable for the given structures of production and technology, especially if the demand push starts early enough. But past crises and recoveries suggest that employment cannot recover overnight.

Compared to 2019, the global employment loss by 2021 is projected to be 90 million jobs while demographic trends suggest an increase in working age population of nearly 90 million people. Assuming that one third of the latter do not enter the workforce, the estimated net increase in unemployment by 2021 would be close to 150 million people. In the 'lost decade' scenario, 29 million of those jobs could be re-created by 2022, compared to 57 million in the 'growth revival' scenario. Unemployment rates are projected to return to pre-crisis levels only by 2025 in the more desirable 'growth revival' scenario – and much later in the 'lost decade' baseline.

2. The environment matters for growth

Employment growth in this scenario results from known dynamics involving the growth of activity and specialization, technology trends and rates of employment relative to output growth. Additionally, a fiscal expansion is assumed to yield tangible employment effects to the extent that social and infrastructure provision tend to be relatively job intensive. What is more, it is expected that policy measures can target job creation. But another important factor to achieve the required job creation is a decisive climate change mitigation strategy. The two components of a green

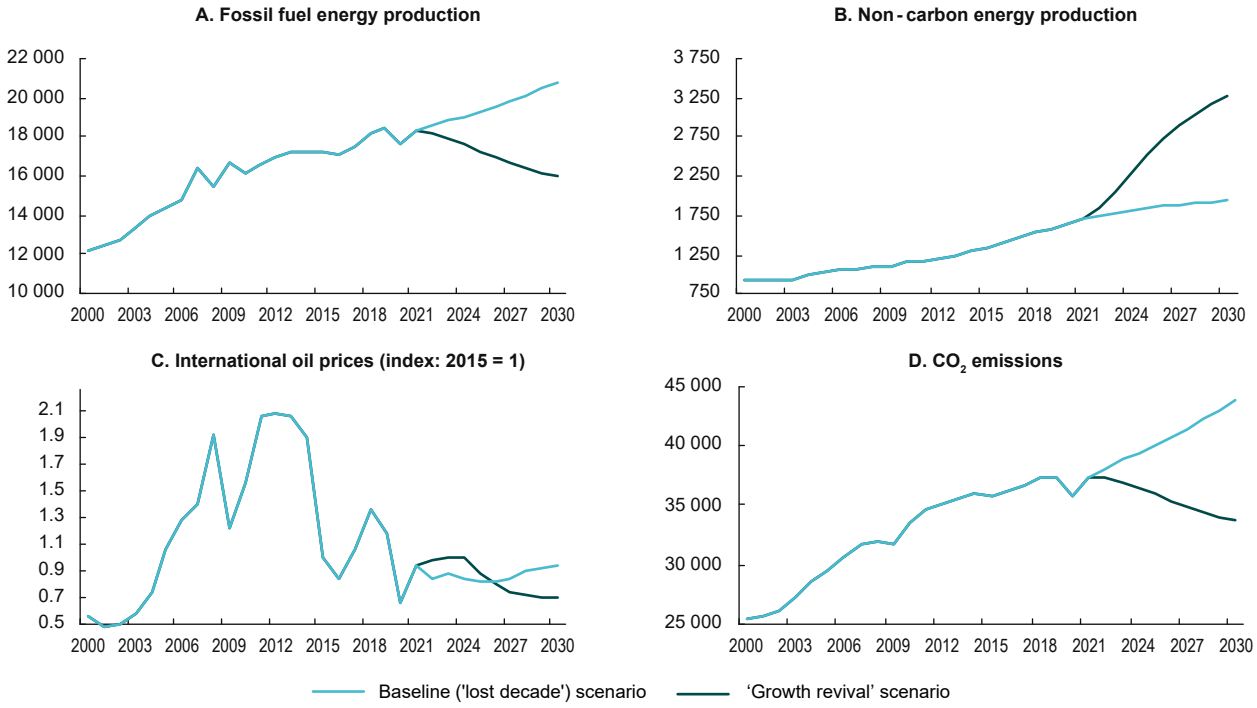
growth strategy – shifting production towards renewable energy and improvements in energy efficiency – can lead to net employment growth even after the loss of employment related to carbon energy is factored in (Ackerman et al., 2015; Godin, 2012; Pollin, 2015, 2018; *TDR 2019*; UNIDO, 2013; van der Ree, 2019).

A successful de-carbonization strategy has to cut carbon energy production by 25 per cent with respect to the ongoing trends by the end of the decade, compensating with higher supply of renewables and greater energy efficiency. Renewables production must break with the slow progress of the recent past. By 2030 it should grow 70 per cent above its trend. This means an annual average growth of 7.5 per cent, compared with the average growth of about 3 per cent experienced through the past two decades. According to the works cited above, this is achievable if supported by a strong investment push. Energy efficiency will have to improve at a rate of 8 per cent per year, a rate actually achieved by several countries in different instances in the past. The green characteristics of this scenario are shown in figure 2.3. CO_2 emissions will fall considerably towards 2030, getting closer to the minimum level required to contain global temperature rising above 1.5°C from the industrial era (figure 2.3D). Not yet ideal, but signifies a notable improvement.

Figure 2.3C shows the evolution of oil prices under the two scenarios. In the baseline, due to the slow growth of global output and the lack of attention to energy transformation, a continuing availability of fossil-fuel energy will keep prices low. By contrast, the initial global impulse of activity and investment of the growth revival scenario will cause some price acceleration. This is however moderate compared with global economic growth because of the simultaneous efforts towards energy efficiency and non-carbon production. Eventually oil prices decline and remain stable at a low level.

On the face of it, this evolution looks like an advantage for oil importers and potentially a disincentive for the energy exporters to adhere to a growth revival scenario of this kind. Yet, as shown above, in this scenario energy exporting economies will manage to experience a growth acceleration and further to sustain rates at more than twice those of the baseline. Aside from the fact that their policy effort in terms of fiscal injections, promotion of private investment and support to wage income will have to be considerable as in other parts of the world, there will be initially some degree of terms-of-trade gains. More importantly, there is a requisite international policy coordination element to this scenario, which is not marginal to achieving its full benefit. Specifically, and as with any global public good, efforts to deliver

FIGURE 2.3 **Global environmental variables, 2000–2030**
(Million tons), unless stated otherwise



Source: see table 2.1.

it have to be shared. In this scenario international investment and technology transfers from North to South are required to transform demand and supply of energy in accordance with global targets. This imperative implies that, especially energy exporting developing economies should be backed in such efforts. As a matter of fact, even if departing from low levels, investments in energy efficiency and non-carbon energy production in these countries must be particularly high and should enjoy technological and financial support.

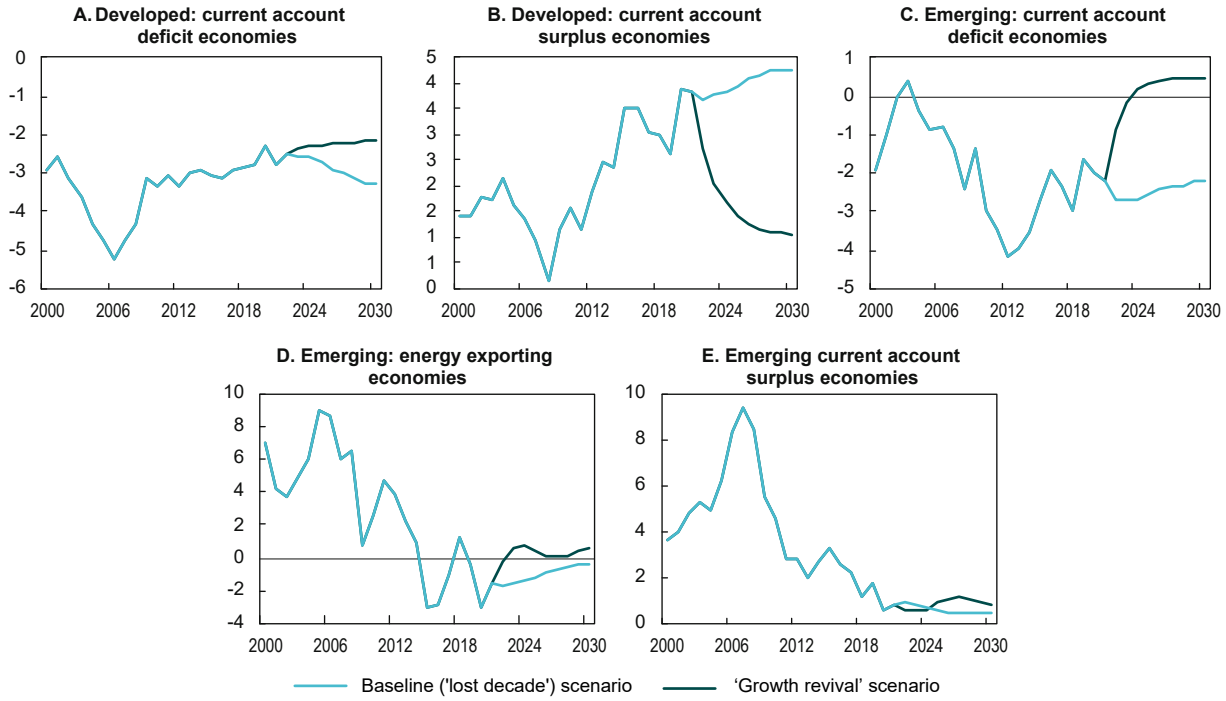
3. The other global common goods: development and external financial balances

The vision underlying the growth revival scenario, consistent with the SDG, requires simultaneous attention to three global public goods: environmental protection, economic development of all nations, and financial stability. Like environmental protection, economic development in a globally integrated economy brings common benefits. This was a driving principle – albeit it breached in practice – of the post-war multilateral order (chapter V) and underpins the design of the SDGs. For similar macroeconomic reasons, the tendency towards current-account imbalances that has marked every cycle of global growth over the past decades is detrimental to growth and stability, and the GFC has been a paradigmatic example. As discussed in section B, efforts to achieve net export surpluses in some economies combined with borrowing-led spending booms in other economies, makes the world economy more fragile. A permanent reduction of external imbalances is a public good.

As also argued in section B, strong domestic demand support in countries with a current-account surplus is necessary to put the world economy on a sustainable and robust growth path, while also promoting industrialization in the South. Combinations of financial support, technology transfers and especially by increasing market access *and* injections of aggregate demand can achieve this goal. This will help to raise the share of exports of manufacturing products produced in the South. As shown in figure 2.4, under this scenario eventually all groups of economies reduce significantly their external positions towards the end of the decade, which is crucial especially for developing economies in view of succeeding in their industrialization objectives, a pending aspiration of the Doha Development Round.

In the growth revival scenario, advanced surplus economies will reduce their imbalances by relying more heavily on faster growth of domestic demand.

FIGURE 2.4 **Current account balance, 2000–2030**
(Per cent of GDP)


A. Developed: current account deficit economies
B. Developed: current account surplus economies
C. Emerging: current account deficit economies
D. Emerging: energy exporting economies
E. Emerging current account surplus economies
Baseline ('lost decade') scenario
'Growth revival' scenario

Source: see table 2.1.

The complementary effort to back industrialization of emerging economies will work in the same direction. Meanwhile, advanced economies running current-account deficits improve their external positions without completely eliminating the deficits. Projections assume that in these countries current-account deficits are pulled in different directions by two policy objectives – the objective of gaining export market shares leads to lower deficits while the promotion of industrialization of emerging economies leads to higher deficits. Importantly, the net effect will be advantageous to advanced deficit economies because in the aggregate the contributions of all economies to global demand will help significantly to improve their external positions. Finally, the growth revival scenario assumes an international financial architecture that functions for global stability and development (chapter V).

4. Tuning the growth impulse and related financial and policy challenges

Table 2.3 below hints at the interaction of growth drivers, outcomes and financial requirements for a growth revival. As also shown in figure 2.1, growth gains in this scenario are considerable, especially for the world as a whole and the first four groups of economies.[17] Yet, they are not beyond the realm of historical experience.

The growth revival scenario breaks with the past when it comes to the structure of demand, in which the main drivers are the growth of private investment and public sector spending. The strong positive effect of government spending in goods and services (including for the energy transition) on private investment found in macroeconomic data ('crowding in') is reflected in the United Nations Global Policy Model. The combination of public sector demand and private investment push is projected to improve infrastructure provision, innovation and green investments in the energy sector, which will bring forward substantive net job creation.

Despite faster growth of government spending relative to the baseline, the shares of government expenditure on GDP remain close to baseline levels, and even below in a couple of instances. This is because government injections generate sustained GDP growth.

The scenario also considers decisive policy efforts to make economic growth more inclusive. These include minimum wage laws, promotion of regularization of labour contracts and social benefits, protection of labour rights including the formation of unions, and the provision of care services and other measures which contribute to gender equality in the workplace (chapter III; *TDR 2017*). As noted in table 2.3, the resulting improvements in terms of rising wage shares are not negligible. Still, the newly experienced wage shares will reach levels that the same economies have experienced in the years of the pre-GFC, which were, in turn, significantly lower than those of the 1990s. In other words, this scenario would only partially reverse decades of lost wage shares.

But the accelerations of public sector spending and the efforts towards inclusiveness, which should touch upon salaries of public sector employees as well, have the potential of stretching public sector finances. Yet, as also shown in the table, public sector debt ratios for the world as a whole will fall from those experienced in 2021, and would be considerably lower than those of the 'lost decade' scenario. Both developed and emerging economies will show a reduction of public sector debt ratios.

A difference of degree is observed in the case of debt ratios of the two groups of advanced economies. Debt ratios of the growth revival scenario will fall from the peaks of 2021 and will certainly be lower than those of the 'lost decade'. But these reductions of the debt overhang are not so significant as they are for emerging economies. Year by year, debt ratios continue to fall, but at a moderate pace and by the end of the decade they will remain above 100 per cent of GDP.

There are two different interpretations of these outcomes for the developed economies. Some observers will raise calls for radical fiscal adjustments on the simple observation that debt ratios higher than, say 100 per cent of GDP, are dangerous. Indeed, the design of the 'lost decade' scenario started from this assumption. But the modelling exercise shows that austerity approaches in the current conditions do not yield reductions of debt ratios. Similar conclusions were shown in the World Economic Outlook 2012 – October (IMF, 2012), where it is noted that, especially in developed economies, fiscal austerity had the effect of growth decelerations (or contractions) which therefore tend to increase debt ratios.

The other reading of the observed patterns of debt ratios of developed economies in this scenario is that, even if high, the ratios are falling, and if the same tenor of fiscal support to inclusive growth is maintained for long enough, the overhang will eventually

TABLE 2.3 **A 'growth revival' scenario compared with the baseline, 2022–2030**
(Per cent)

	World economy	*Developed: current account deficit economies*	*Developed: current account surplus economies*	*Emerging: current account deficit economies*	*Emerging: net energy exporting economies*	*Emerging: current account surplus economies*
GDP growth:						
average 2022–2030 [baseline]	2.0	1.0	0.9	2.3	1.9	4.3
['growth revival' scenario]	3.8	2.8	2.6	5.0	4.7	5.3
Private investment growth:						
average 2022–2030 [baseline]	3.8	2.0	2.1	2.3	2.8	5.9
['growth revival' scenario]	6.0	5.6	6.4	6.6	7.8	5.1
Government spending growth:						
average 2022–2030 [baseline]	1.2	-0.1	-0.2	2.1	1.5	2.3
['growth revival' scenario]	3.1	2.4	2.1	4.1	3.8	3.4
Government spending [percent of GDP]:						
average 2022–2030 [baseline]	19.8	18.6	22.6	18.1	22.2	18.3
['growth revival' scenario]	19.9	19.1	23.4	17.1	21.8	18.9
Government debt ratio [per cent of GDP]:						
at year 2021	89.6	119.7	123.4	84.5	56.8	65.8
at year 2030 [baseline]	91.8	139.6	128.7	105.2	67.8	48.1
['growth revival' scenario]	76.3	113.7	115.5	70.7	43.9	53.6
Share of labour income:						
average 2022–2030 [baseline]	49.8	51.1	51.5	45.0	44.4	54.2
['growth revival' scenario]	54.0	56.5	55.9	49.7	48.7	57.3

Source: see table 2.2.
Note: see table 2.2.

disappear. Taking this approach in the face of more conventional economic reasoning that is bound to appear will require leadership and determination.

More generally, moving in the direction of the growth revival scenario proposed here calls for policy focus and bold measures. Domestically, economic planning and industrial policies will be essential; internationally, policy coordination will be needed. Though both approaches have been part of the policy discourse in the past, implemented by both advanced and emerging economies to some degree, they imply a change of course with respect to the current policy mindset.

There should be no denying the fact that changing course is becoming harder over time. Self-restraint by policymakers, sometimes to even discuss the possibility of stimulus, has become habitual, effectively reducing the institutional space to operate. Governments have downsized in the name of austerity, outsourcing and privatizations, but the size of their financial obligations have expanded disproportionally by absorbing debts contracted elsewhere.

In honouring debts, promoting the creation of liquidity to rescue bank balance-sheets, and relaxing the rules, they have contributed to the creation of financial giants that are "too big to fail". Thus, States have not only become smaller but also weaker in comparison. Meanwhile, the enlargement of rights, protections, favourable tax treatment to corporations, and other forms of abidance to corporate power and international investors has, *pari passu* reduced the ability of workers to raise their wages (Müller et al., 2019; Polaski, 2018; *TDR 2017, 2019*). Effective unemployment and the rising threat of job losses for those at work diminish their ability to strive for change.

Still, under the present conditions where States and wage earners are relatively weak, they still represent the sole possibilities of raising effective demand to avert a continuing global economic decline that will leave all parties worse off. To realize such possibilities, the role of fiscal policy has to be reinstated; corporate power has to be regulated in exchange for a continuing and stable source of prosperity; credit instruments to sustain production while averting speculation have to be reinvented; and employment and fair remunerations ensured.

The argument, after a crippling financial meltdown that led to a decade of insipid growth and increasing financial fragility, should be obvious in light of the Covid-19 crisis. What remains to be seen is whether there is the political willingness to coordinate a global recovery plan.

Notes

1 Previous TDRs have argued that the world economy that emerged from the GFC systematically failed to generate robust and self-sustained growth (see also Chandrasekhar and Ghosh, 2020; El-Erian and Spence, 2020; Storm, 2019a).

2 To avoid confusion the term saving, unless otherwise indicated, is used as a synonym of 'net financial saving' or the total of revenues minus the total of current and investment expenditure. Especially in dealing with the public sector there is little purpose in using 'saving' as revenue minus current expenditure only. But more generally, what matters for the accumulation of debt is the concept of saving (or rather its opposite: dissaving) to the extent that expenditures beyond income have to be paid by either borrowing or by the liquidation of assets. In passing, note that for this reason 'net financial saving' is also called 'net acquisition of financial assets'.

3 From a complementary perspective, it is noted that mainstream models miss the relevance of credit in supporting a growing economy because the possibility of default is entirely ruled out, which will then make the very existence of money and credit totally unnecessary (Goodhart et al., 2013; Lagos, 2006).

4 From a national accounting perspective, the two internal financial balances, of the public and the private sector add exactly to a current-account surplus.

5 The tendency towards instability in relation to the growth of external flows and interest rate differentials was underscored early on by Evsey Domar (Kregel, 2008; Taylor, 2019)

6 A similar phenomenon to that at the origin of the de-industrialization in the deficit countries of the South (Akyüz, 2020; United Nations, 2006).

7 Data collected by the UN-DESA Statistical Division and other international organizations (IMF and World Bank), further compiled with the UN Global Policy Model (GPM henceforth).

8 The only value judgement involved the quantification of a composite index of the structure of demand, which is explained further below. The index serves no other purpose than to help organize the information.

9 The quantification of net leakages would be the ex-post growth equivalent of the "savings glut" notion used by the former Chairman of the Federal Reserve of the United States, Ben Bernanke, to argue that the then large current-account surplus of China and other countries exert a downward pressure on the interest rates of the United States (Bernanke, 2005). Neither its theoretical explanation of global imbalances (which has many shortcomings; see Patnaik, 2009; Borio and Disyatat, 2011) nor such static connotation (surpluses versus deficits), is assumed here. Net injection or leakages should be interpreted as contributions (or its opposite) to the growth of demand.

10 The index gives an initial value depending on whether the economy is a net contributor to the growth of global demand (column [2]) and whether its growth of absorption is faster than the pace of absorption of the rest of the world (column [6]). To this, a normalized value of structural change is added (column [5]). Finally, another normalized value is added if the main growth driver is triggered by a net injection of the public sector (column [4]), which is considered less subject to financial instability threats than private sector leveraging.

11 Of the 11 economies (out of 30) which had net contributions to the growth of global demand, only 3 of them achieved this with positive injections of public sector demand. Of the 3 developed economies (in the 11), two adopted fiscally contractionary stances. This applies to the United Kingdom and the group of European Union economies excluding France, Germany and Italy (which are in the group of 'outright global deflationary stances'). The case of the United States is peculiar because the bulk of net public sector injections over the period 2018-19 represented mostly tax rebates (and mainly to the corporate sector). These, instead of propelling stronger growth of spending in the private sector as intended, seem to have supported a net savings impulse of about the same speed (private sector leakages).

12 The estimates for 2020-2021 are based on preliminary statistical information available (GDP growth quarterly reports to 2020 Q2, surveys, employment and income reports, etc.) and makes projections on similar assumptions made by other international organizations. Outcomes show some difference: in this report, contractions this year are estimated to be marginally less severe and the 'technical recovery' next year relatively less strong than elsewhere. In standard models of other international organizations, the importance attributed to supply-driven shocks is somehow exaggerated given the exogenous character of the lockdowns, while the same models do not generally yield meaningful fiscal spending multipliers as the United Nations GPM does.

13 See the footnote under table 2.2. There are, however, unavoidable ambiguities given variations of current-account positions over time. A somehow ambiguous case is the classification of France as a 'surplus'

economy. It has been in deficit for most of the GFC and post-GFC periods but has shown persistent tendencies towards surplus in virtue of domestic demand compression. Expected adjustments during 2020 and 2021 are likely to strengthen this tendency. Further, the emerging energy-exporting economies form a separate group. Most of these economies have been patently in surplus during boom periods and have, conversely fallen into deficits during energy price slumps. Finally, among the 30 countries/groups of the GPM, there are only two cases of emerging economies classified as current-account surpluses: China and 'other East Asia'. The latter includes the known newly industrialized economies (see table 2.1 footnote). China is experiencing changes in its demand pattern; going forward, it is expected that such realignment would be maintained but not to the extent of bringing the external balance patently into deficit.

14 The degree of austerity imposed as assumption is derived from the assessment of empirical evidence that integrates the macro-financial conditions (volume of debt, relative size of government spending, revenues, transfers, public sector employment, and other factors) within the structure of each economy and presupposes that the prevailing policy approach does not change. The scenario further incorporates initial conditions regarding unemployment rates and declining wage shares by drawing reliable patterns from earlier crises, either global or regional crises, or country-specific events over the last three decades. As the United Nations GPM is an econometric macro-financial model within a tight accounting structure, the starting estimation process runs through various iterations of assumed changes based on the available information, until reliable and globally consistent initial conditions are achieved to allow the model to generate endogenously the mid-term outcomes.

15 A special consideration should be made about the grouping of emerging surplus economies, which is mostly reflecting the Chinese economy. In this case, current growth rates are lower than those of the past as the economy shifts towards more resilient domestic demand and away from fast growth of exports, while continuing to pursue a demand-led strategy. The Covid-19 shock has not patently changed this trend.

16 Meanwhile, the scenario does not assume shocks of that kind in the future (though the disappointing global growth performance of 2022 triggered a mild shock to prices). Overall, a relatively smooth pattern of global energy demand, would lead to an equally moderate but stable investment in the extractive industries.

17 The group in the last column includes economies whose growth trajectories have not been so sharply disrupted by the pandemic. Some of these, especially China, are assumed to persevere in their current demand-led efforts towards internal restructuring. Therefore, for these economies both scenarios are relatively similar in terms of domestic policy; the differences reflect mostly the de-carbonization strategies and global feedbacks.

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Annex:
Derivation of macro-accounting decomposition relations

Table 2.1 is calculated on the basis of two complementary approaches to the macro-accounting decomposition of GDP growth: one with emphasis on the external – internal characteristics of the growth of demand, and the other one with emphasis on the public - private sector divide.

Domestic - external decomposition of GDP growth: relative paces of absorption and structural change

$V_t \equiv A_t + X_t - M_t$ with V: GDP, A: domestic absorption, X: exports; M: imports [1]

let $g_{Z,t} = \Delta Z_t / Z_{t-1}$ be the growth rate of variable Z in discrete time

$$g_{V,t} = \phi_{A,t-1} g_{A,t} + \phi_{X,t-1} g_{X,t} - \phi_{M,t-1} g_{M,t} \quad [2]$$

where $\phi_{j,t}$ is the share of expenditure "j" in GDP during period t.

Given that $1 = \phi_{A,t-1} + \phi_{X,t-1} - \phi_{M,t-1}$, it follows that:

$$g_{V,t} = g_{A,t} + \phi_{X,t-1}(g_{X,t} - g_{A,t}) - \phi_{M,t-1}(g_{M,t} - g_{A,t}) \quad [3]$$

Add and subtract $\phi_{X,t-1} g_{WA,t}$ to the righthand side of (3), where $g_{WA,t}$ is absorption of the RoW:

$$g_{V,t} = g_{A,t} + \phi_{X,t-1}(g_{WA,t} - g_{A,t}) + \phi_{X,t-1}(g_{X,t} - g_{WA,t}) - \phi_{M,t-1}(g_{M,t} - g_{A,t}) \quad [4]$$

In words, for any country, GDP growth of an open economy can be decomposed in terms of:

- The expansion of domestic demand: $g_{A,t}$,
- The relative difference in growth rates of absorption of the RoW and domestic: $\phi_{X,t-1}(g_{WA,t} - g_{A,t})$,
- The change in the import propensity of the RoW: $\phi_{X,t-1}(g_{X,t} - g_{WA,t})$, and
- The change in the import propensity of domestic demand: $\phi_{M,t-1}(g_{M,t} - g_{A,t})$.

The second item shows the differences of speed of domestic absorption between the rest of the world and the economy in question. It is captured in Column [6] of table 2.1. Negative values imply the economy's absorption grows at a faster rate than the world partners. The last two items represent structural change: gains in export markets shares and (relative) import substitution. These two, added to the 'negative' value of the previously mentioned item (i.e. how fast the domestic economy grows relative to the rest of the world's absorption) generate the value for column [5] of table 2.1.

Structural decomposition of absorption into public-private injection and implied distribution

$A_t \equiv G_t + P_t$ with G: govt expenditure; P: private expenditure (consumption + investment) [5]

$Y_t \equiv Yg_t + Yp_t$ with Yg: government revenue; Yp: private disposable income [6]

$$g_{A,t} = \propto_{t-1}.g_{g,t} + (1 - \propto_{t-1}).g_{p,t} \qquad \text{with } \propto_t = \frac{G_t}{A_t} \qquad [7]$$

$$g_{Y,t} = \beta_{t-1}.g_{Yg,t} + (1 - \beta_{t-1}).g_{Yp,t} \qquad \text{with } \beta_t = \frac{Yg_t}{Y_t} \qquad [8]$$

Add and subtract $\propto_{t-1}.g_{Yg_{,t}}$ and $(1 - \propto_{t-1}).g_{Yp_{,t}}$ to the righthand side of (7):

$$g_{A,t} = \propto_{t-1}.(g_{g,t} - g_{Yg,t}) + (1 - \propto_{t-1}).(g_{p,t} - g_{Yp,t}) + \{ \propto_{t-1}.g_{Yg,t} + (1 - \propto_{t-1}).g_{Yp,t} \} \qquad [9]$$

Using [8], the term in the curly brackets can be replaced, resulting in the following expression:

$$g_{A,t} - g_{Y,t} = \propto_{t-1}.(g_{g,t} - g_{Yg,t}) + (1 - \propto_{t-1}).(g_{p,t} - g_{Yp,t}) + (\propto_{t-1} - \beta_{t-1}).(g_{Yg,t} - g_{Yp,t}) \qquad [11]$$

The expression shows that the difference between the growth of absorption and of national income, in the LHS, can be fully explained by the contributions of the public and private stances, the first two terms in the right-hand, and a *distributional adjustment*: $(\propto_{t-1} - \beta_{t-1}).(g_{Yg,t} - g_{Yp,t})$

The growth of aggregate absorption (the LHS of the equation) is captured in column [2] of table 2.1 (with the growth of national income included as memo item in column [1]). Public and private sector stances are straightforward estimates of the weighted contributions of the gap between the growth of spending and income. Positive numbers imply the macroeconomic tendencies of spending to generate effective demand and therefore economic growth. These are included in columns [3] and [4] of table 2.1, for private and public sectors, respectively, after adding to the stronger of the two injections the *distributional adjustment*.

The *distributional adjustment* is an accounting result that absorbs differences of the growth rates of private and public sector income which follow from the growth of aggregate income (which is in turn an ex-post result of the growth of effective demand). The adjustment is a relatively marginal value because the first term would generally be within [-0.03;+0.03], as the *shares* of expenditure of each sector cannot be very different than its shares of income. The relatively more significant changes can be in the second term of the adjustment. First, growth alters incomes across deciles of taxpayers. There is no imputation of such changes, but these are captured in the national accounts as ex-post values. Second, there can be policy-driven changes of regime in terms of taxes, subsidies and transfers implying shifting resources from one sector to the other. These are also contained in the national accounting statistics; no additional imputation is made. Worth noticing is the sign of the distributional adjustment:

a) $(\propto_{t-1} - \beta_{t-1})$ represents whether the share of expenditure of the public sector in the prior period was greater than its share of income. A positive number means a 'stronger' public sector stance than private sector stance in the previous period. Needless to say, either or both public and private sector stances could have been positive or negative at each point in time; the higher share of expenditure relative to the share of income of one sector with respect to the other simply means that the injection of the former was stronger or its leakage was weaker.

b) $(g_{Yg,t} - g_{Yp,t})$ simply shows relative differences of income growth: whether public sector revenue growth in the current period is faster than the growth of private disposable income

c) Hence, a 'positive' sign of the distributional term (= [+].[+] or [-].[-]) tells that the sector whose *injection was stronger* (weaker) in the previous period is *increasing its income at a faster* (slower) pace in the current period. Hence, *a positive term suggests that the distributional dynamics operating through the tax/subsidy system are conducive to growth since distribution would favour the sector which was most effective at sustaining aggregate demand*. Conversely, a negative sign implies a perverse distributional mechanism by which a sector which had relatively stronger contribution to growth, thus increasing its deficit or reducing its surplus, would be adversely affected by changes in the tax system which would erode its share of revenue.

RECOVERING BETTER: THE INEQUALITY CHALLENGE IN A FRACTURED ECONOMY

III

A. Introduction: What is happening to inequality during the pandemic?

A sustainable, equitable recovery from the Covid-19 recession depends on reducing inequalities that have vexed humanity for decades but have intensified under the pressures of hyperglobalization (*TDR 2017*) and the emergence of new technologies (*TDR 2018*). Based on trends in functional income distribution – that is, the distribution of value added between wages, profits, rents and taxes – pre-existing structural weaknesses in the global economy, if left unaddressed, are likely, as happened after the GFC, to lead to a short-lived and uneven recovery.

When the Covid-19 shock hit, vast swaths of the global economy were already in a precarious state. Recovery from past crises had left a woeful situation: many workers squeezed by stagnant wages, states still in the grip of austerity, and corporations awash in unhelpful credit. While the pandemic caught the world by surprise, with this background it should be no surprise that the economic consequences have been so alarming.

If the world economy is to move away from the edge of depression and claw its way back toward sustainable growth and development, it must recover more effectively than it did from the GFC a decade ago by repairing a series of cumulative economic, social and environmental fractures. The keystone of a better recovery is redistribution of income, adapting the rules, norms and institutions that comprise the social contract so that going forward the gains from economic activities are more fairly distributed.

Full data on the impact of Covid-19 on personal income and wealth inequalities will only become available in a few years. But we know for certain that socio-economic inequalities are of pressing importance for policy responses to the pandemic. One reason is that current policies may be having regressive effects. Research on recent epidemics – including SARS (2003), H1N1 (2009), MERS (2012), Ebola (2014) and Zika (2016) – indicates that containment efforts and other policy responses have led to lower incomes and worse medium-term employment prospects especially for lower-wage workers (Furceri et al., 2020).

Furthermore, the scale of what the world faces with Covid-19 far outstrips recent public health crises. Immediately measurable variables, like employment and income, show drastically larger effects than prior epidemics. The number of unemployed people, for example, is equivalent to more than the entire population of the European Union, an impact that would have been unthinkable during the worst of the SARS or Ebola outbreaks.

Poverty is set to increase sharply as a result of the pandemic, with as many as 200 million more people living on less than $5.50 per day, heavily concentrated in South Asia and sub-Saharan Africa (World Bank, 2020). Moreover, as the United Nations Special Rapporteur on extreme poverty has noted, Covid-19 has lowered the curtain on some of the rosier accounts of poverty reduction in recent decades to reveal "a world where poverty, extreme inequality and disregard for human life are thriving, and in which legal and economic policies are designed to create and sustain wealth for the powerful" (Alston, 2020).

Early analyses of specific policy responses to Covid-19 suggest an amplification, rather than dampening, of inequality. Benefits appear to be accruing disproportionately to the wealthy (JCT, 2020; Boushey and Park, 2020). The staggering increase in the wealth of the super-rich since the lockdown has been widely reported (Oxfam, 2020; Rigby, 2020) and, in many advanced economies efforts to relieve

tensions in financial markets have surged ahead even as measures to help ordinary workers suffer from delay, or poor execution (Brenner, 2020).

These shortcomings, combined with the scale of what the world faces, and the persistent structural issues apparent since at least the GFC, suggest that in the absence of decisive, and in many countries, revised policies to protect the most vulnerable and address structural barriers to fairer income distribution, inequality will increase, possibly dramatically.

The rest of the chapter is organized as follows. Section B summarizes the prevailing approach to inequality in global policy discussions and signals missing factors. Section C presents global trends in the labour income share while their determinants are taken up in the following two sections. Section D discusses the dynamics of real wage growth and the impact of widespread wage repression. Section E discusses the dynamics of productivity growth presenting data in a framework that highlights specific challenges for developed and developing countries. Section F builds on this framework showing how, through policies and institutions, differences in productivity performance between sectors have developed into economic polarization. Section G discusses the shift in policy approach necessary to dial back economic polarization and generate a recovery that leads to sustainable growth and development. Given data constraints, the chapter focuses on G20 countries.

B. Missing characters in the global inequality narrative

Debates around trends in inequality are beset with definitional and measurement challenges (Galbraith, 2016; McGregor et al., 2019). That has not stopped the issue of inequality from being extensively researched in recent years as gaps in both income and wealth, between individuals, across regions, within countries and amongst countries, have become a topic of heated political (and policy) discussion.

That research has exposed a good deal of nuance in the evolving patterns of inequality, with local circumstances and policy measures oftentimes reinforcing, but at other times counteracting, larger global economic forces. Still, broadly speaking, both in the world as a whole and within the majority of countries, income inequality is higher today than it was 40 years ago, and wealth inequality sharply higher. Moreover, despite a general recognition that heightened inequality was a contributing factor to the global financial crisis of 2008-09, the past decade has not seen any significant reversal of these trends and on some measures the situation has actually worsened. Covid-19 is likely to widen income and wealth gaps even further (Furceri et al., 2020; Boushey and Park, 2020).

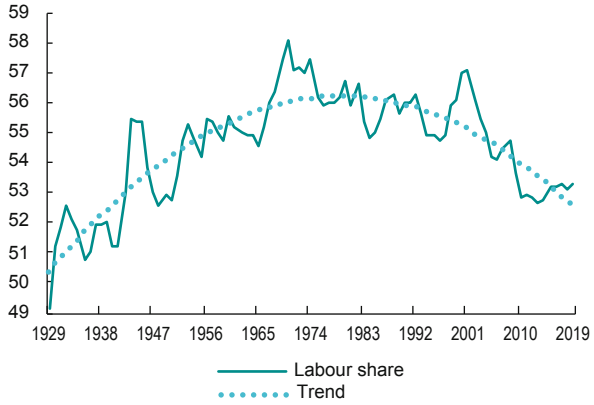
Beyond country-specific factors, the strong common forces behind the rise in inequality are fiscal austerity as the blanket policy response to macroeconomic imbalances (*TDR 2017*; *TDR 2019*) and the emergence of hyperglobalization, especially in the form of growing financialization of the world economy and rising concentration of corporate power in production, finance (*TDR 2017*) and international trade. The latter in particular has tied countries in unequal relations established around global value chains and more recently digital platforms (*TDR 2018*).

With inequality emerging as a major political concern, international policy discussions have made appeals to "leave no one behind" (United Nations, 2019) but have lacked a convincing narrative linking the rise of inequality to the challenges of growth and development. This, in part, reflects a longstanding focus on poverty as the preferred measure of economic injustice and a resort to listing ad hoc government failures as an explanation of misguided adjustments to the presupposed beneficial spread of market forces and technological progress.

Institutional factors and policy choices certainly have a determining influence over the distribution of income. However, this view misses a crucial point. Most of those who have experienced absolute or relative declines in economic well-being have not been excluded from the processes of hyperglobalization. But their inclusion in it involves playing by a set of rules and norms that by design exclude them from the benefits while subjecting them to many of its costs.

What we need to understand is functional income distribution, which is the distribution of value added among wages, profits, rents and taxes. Given the way conflicting interests and unequal bargaining power play out through the rules of the economic game, this concept offers a sharper lens through which to examine those rules. In both developing and

FIGURE 3.1 Labour income share in the United States, 1929–2019
(Percentage of GDP)



Source: United States Bureau of Economic Analysis.

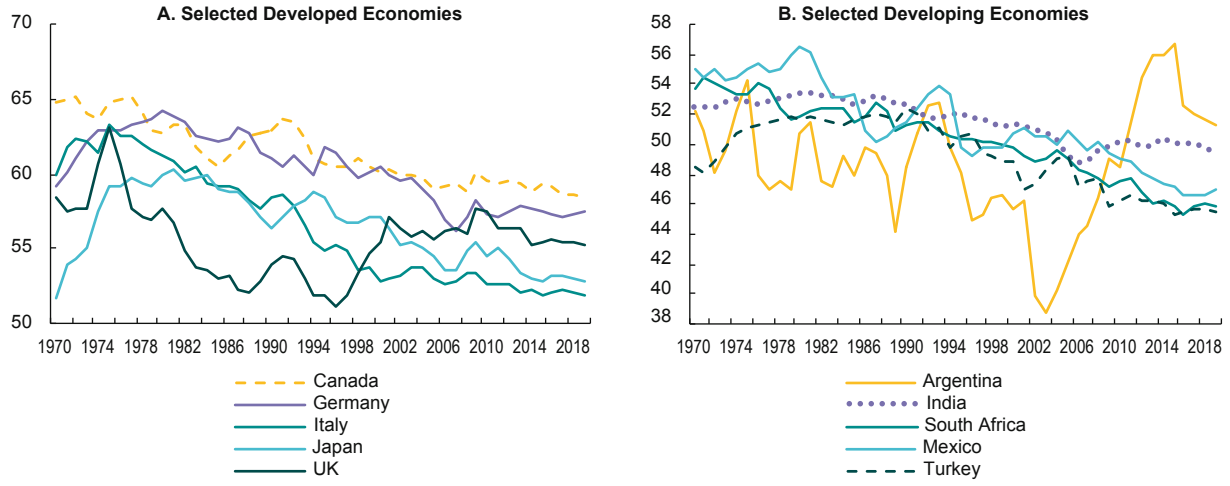
advanced economies, this process reflects the way income and wealth are generated, and distributed, in the production process.

By focusing on functional income distribution, we can begin to understand not only cyclical dimensions of economic recovery, but more structural and cumulative pressures. These forces can turn market forces into sources of economic polarization, whether through first-mover advantages and scale economies, rent-seeking behaviour and market concentration, or unequal terms of trade and the international division of labour.

Looking beyond the Covid-19 crisis, an important question is whether the labour share of income can be expected to increase more permanently when economies recover. The answer is negative unless a profound shift in policymaking occurs. The labour income share has displayed a downward trend in many economies, both developed and developing, since the 1980s, with a corresponding rise in the profit share. The proximate cause has been wage repression, due to the weakening of labour market institutions, which has prevented wages from keeping pace with increases in productivity and, in many cases, the cost of living. If pre-pandemic trends resume after the crisis the labour income share will continue to recede, dimming any prospects of a sustainable recovery of the global economy.

The United States provides a telling example. The decline of its labour share of income began in the early 1970s, earlier than most other advanced economies, and with a particularly steep fall in the last twenty years. In 2007-08, it briefly increased as the first wave of insolvency hit the economy and the GFC began (figure 3.1). Subsequently, despite a recovery of economic activity and record-low unemployment, the labour income share did not go back to its pre-crisis level. In 2019 it was approximately 2 percentage points of GDP below its 2009 level, at a level (53.3 per cent) last seen in the early 1950s. If these structural forces continue to play out, by the next decade the labour income share in the United States may reach the level of 1930. Other advanced and emerging economies have also exhibited a similar pattern as of 1970 (figure 3.2).

FIGURE 3.2 Labour income share, selected economies, 1970–2019
(Percentage of GDP)



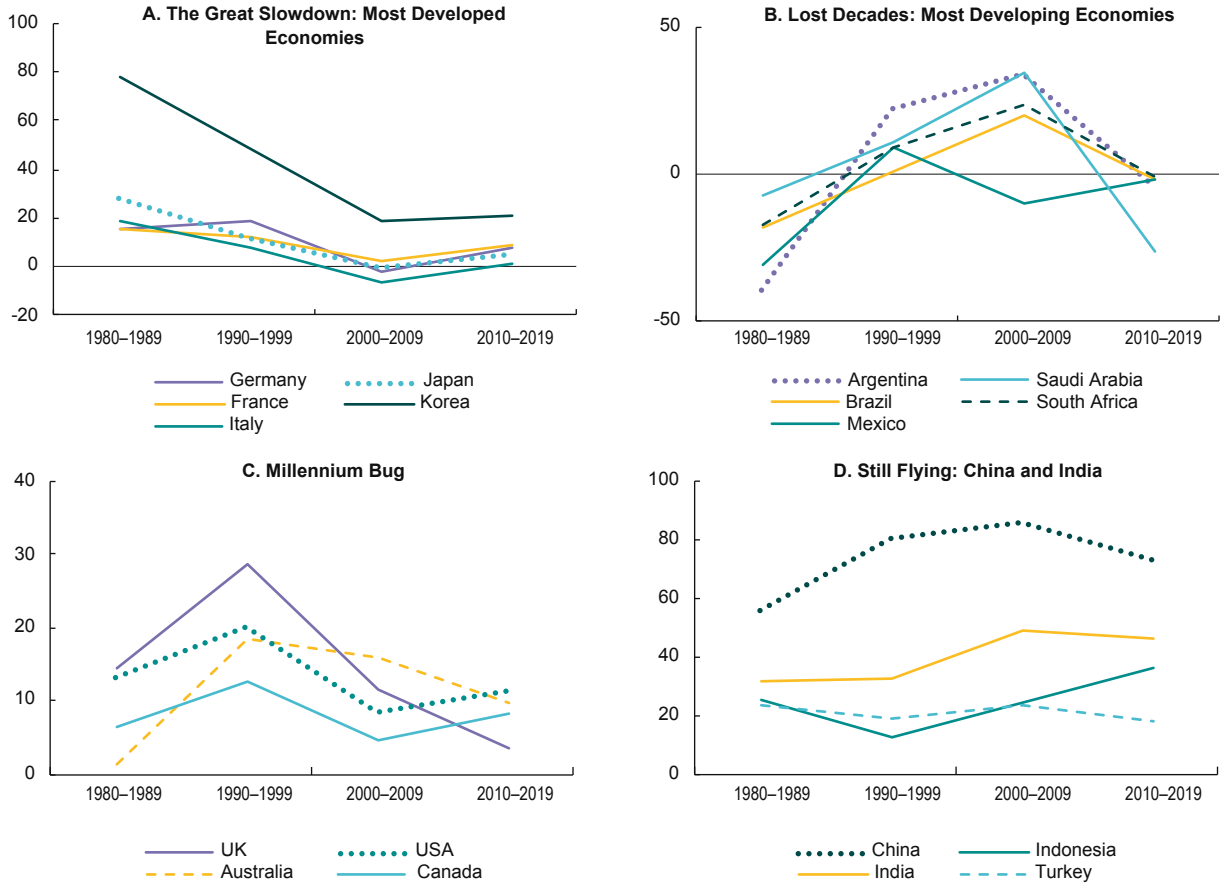
Source: United Nations Global Policy Model.
Note: Labour income share is calculated as ratio of employees' compensation and mixed income to GDP.

If the pre-Covid-19 forces of wage repression remain in place, there will probably be a new decline in the labour income share in many economies in the coming years, with negative consequences not only for the pace of recovery but for income inequality and economic and social stability (*TDR 2019*). But the future has not been written yet. The Covid-19 pandemic is a profound shock that may change the determinants of income distribution structurally. It is too early to know in which direction. If the world embarks on a more inclusive and sustainable path of economic development, as discussed in chapter II, real wages can recover in a context of higher employment, faster productivity growth and sustainable development. That would reduce income, and eventually, wealth inequality.

C. Global trends in the labour income share

With the exception of Argentina and Brazil, workers in all G20 countries had lower income shares in 2019 than they did in 1980 (table 3.1). To understand how this happened it is useful to look at the labour income share as the ratio of the unit labour cost (the average real wage, hourly or annual) to the total income produced with that labour (average labour productivity). For example, in the 2010s in Italy real wages grew 1.1 per cent and average productivity increased 2.9 per cent. The difference between these rates yields the growth rate of the labour income share, which was in fact a contraction of 1.8 per cent. As real wages and productivity change over time, they drive the labour income share up or down. In general, a decline of the labour income share can take place under three circumstances:

FIGURE 3.3 **Real wage growth, selected countries, 1980–2019**
(10-year percentage point changes)



Source: United Nations World Economy database and Global Policy Model.

TABLE 3.1 **Change in the labour income share and its determinants, G20 countries, 1980–2019**
(10-year percentage point changes)

		1980–1989	1990–1999	2000–2009	2010–2019
Argentina	labour share	-4.7	-5.9	6.0	7.6
	real wage	-39.5	21.9	33.8	-4.3
	productivity	-34.8	27.8	27.8	-11.9
Australia	labour share	-4.7	-1.9	-3.0	-0.7
	real wage	1.5	18.3	16.1	9.8
	productivity	6.2	20.3	19.1	10.5
Brazil	labour share	0.8	-0.4	4.7	-0.1
	real wage	-18.0	0.9	20.0	-1.6
	productivity	-18.8	1.3	15.2	-1.5
Canada	labour share	0.2	-4.4	-1.2	-1.9
	real wage	6.6	12.5	4.8	8.1
	productivity	6.4	16.9	6.0	10.1
China	labour share	-4.9	-2.8	-10.0	4.4
	real wage	55.5	80.8	86.1	73.2
	productivity	60.4	83.6	96.1	68.8
France	labour share	-8.4	-3.0	0.0	-1.3
	real wage	15.2	11.8	2.4	8.7
	productivity	23.6	14.7	2.3	10.0
Germany	labour share	-5.0	-1.1	-5.4	-0.4
	real wage	15.6	18.5	-2.3	7.5
	productivity	20.6	19.6	3.1	7.9
India	labour share	-1.4	-2.3	-2.4	-2.3
	real wage	31.7	32.1	48.5	46.4
	productivity	33.2	34.4	50.9	48.6
Indonesia	labour share	-3.9	-2.8	-4.3	-0.1
	real wage	24.8	12.4	23.8	36.5
	productivity	28.7	15.2	28.1	36.6
Italy	labour share	-4.7	-9.9	-0.5	-1.8
	real wage	19.0	7.4	-6.4	1.1
	productivity	23.7	17.3	-6.0	2.9
Japan	labour share	-6.2	1.5	-4.6	-3.8
	real wage	27.9	11.7	-0.2	4.7
	productivity	34.1	10.3	4.3	8.4
Mexico	labour share	-9.3	-1.5	-3.4	-3.2
	real wage	-30.9	8.7	-10.5	-1.8
	productivity	-21.6	10.2	-7.1	1.3
Republic of Korea	labour share	5.4	-0.8	-7.2	0.4
	real wage	78.2	48.6	19.1	21.5
	productivity	72.8	49.4	26.3	21.1
Russian Federation	labour share	-1.1	-14.1	11.9	-4.5
	real wage	41.6	-37.0	47.0	4.4
	productivity	42.7	-22.9	35.1	9.0
Saudi Arabia	labour share	-2.5	-7.2	-5.5	-3.8
	real wage	-7.4	10.3	34.1	-26.3
	productivity	-4.9	17.4	39.6	-22.5
South Africa	labour share	-1.2	-2.8	-4.7	-3.8
	real wage	-17.9	9.3	23.9	-1.4
	productivity	-16.7	12.0	28.6	2.4
Turkey	labour share	1.4	-7.0	-5.4	-1.9
	real wage	23.5	18.6	22.9	18.3
	productivity	22.0	25.7	28.3	20.2
United Kingdom	labour share	-6.6	2.9	3.4	-4.2
	real wage	14.4	28.8	11.6	3.6
	productivity	21.0	25.9	8.2	7.8
United States	labour share	-1.2	-0.1	-7.3	-0.4
	real wage	13.3	20.0	8.4	11.3
	productivity	14.6	20.1	15.6	11.8

Source: UNCTAD secretariat calculations based on United Nations Global Policy Model.
Note: Growth rates are approximated as log differences for time additivity.

- The real wage falls while labour productivity increases.
- Both the real wage and labour productivity increase but the real wage grows slower than productivity.
- Both the real wage and labour productivity fall but the real wage falls faster than labour productivity.

Over long periods of time both labour productivity and the real wage tend to grow, making case 2 the normal occurrence since 1980. In G20 countries pre-pandemic dynamics have been of four types (figure 3.3). The first consists of a decades-long slowdown, of 40 years in some cases, in the advanced economies of Europe and East Asia. The slowdown bottomed out after the Great Recession, with outright real wage contractions followed by slow growth. The second type consists of deep wage contractions in the 1980s and in the 2010s, which have left some countries with little or no real wage growth for as long as four decades. This has been the case for most developing countries, despite hardy predictions that free trade would eliminate international differences in input prices (Samuelson, 1948; World Bank, 2019).

The third type includes Australia, Canada, the United Kingdom and the United States and features an acceleration of wage growth in the 1990s followed by a sharp deceleration in the 2000s. In Australia and the United Kingdom, the deceleration continued through the 2010s, while in Canada and the United States real wage growth partially recovered.

The fourth type of dynamics consists of fast and sustained real wage growth since the 1990s. It has appeared in the fast-growing developing economies of Asia and in Turkey. In Turkey, real wage growth has been remarkably stable around 20 per cent per decade since the 1980s.

The general deceleration of real wage growth can be partly explained with a slowdown in labour productivity growth, which has taken place in most G20 countries since the 1990s. As is discussed below, this can be due to changes in productivity growth in each sector and to changes in sectors' shares of total employment. But the change in average productivity growth does not account for the full change in real-wage growth. The portion of productivity gains that accrues to workers also fell because of wage repression, that is, a reduction in the bargaining power of workers in almost all G20 economies since the 1980s.

D. Determinants of wage repression

Three main narratives have been proposed to explain the loss of labour's bargaining power and attendant wage repression as they have happened since the 1970s, especially in developed economies.

The first narrative focuses on technological progress. It assumes that adoption of new technologies in each sector is an exogenous phenomenon and analyses its consequences on the labour market. Claiming that newer technologies have increased demand for higher-skilled workers and reduced demand for lower-skilled ones, i.e. technological change is skill-biased, a first version of this narrative derives changes in occupational wage growth from changes in occupational labour demand (Katz and Murphy, 1992; Autor et al., 1998; Goldin and Katz, 2010). But this version fails to explain some important wage patterns of the 1990s and 2000s (Howell and Wieler, 1998; Sanders and ter Weel, 2000; Card and DiNardo, 2002). Looking at tasks rather than occupations, a revised version claims that skill-biased technical change operates in favour of both the top and the bottom of the wage scale but against the middle (Autor et al., 2002, 2008; Autor, 2010; Acemoglu and Autor, 2012; Acemoglu and Restrepo, 2020). While it accounts for the much discussed "job polarization", this version too misses important wage patterns (Mishel et al., 2013; Bogliacino, 2014).

The second narrative focuses on globalization. It highlights the channels through which trade and investment liberalizations have affected wage growth in developed and developing countries, including competition on market shares (Capaldo, 2015; Capaldo and Izurieta, 2018; Kohler and Storm, 2016), import price competition (Petri and Plummer, 2016; Autor et al., 2014), and regulatory capture (*TDR 2014*; Kohler and Cripps, 2018). While the various studies differ greatly in terms of methods, results and remedies, a consensus has emerged about possible negative effects of trade and investment liberalization on income distribution in developed countries and some developing ones (Jenkins, 2006; Autor et al., 2014; Pavcnik, 2017; Rodrik, 2018; *TDR 2019*).

A variant of the globalization narrative looks at the impact of migrations on wage growth. Studies point to complex effects but suggest that migrations negatively affect wages when migrant workers are not effectively protected by labour market legislation (Brücker and Jahn, 2011; Costa, 2019; Blau and Mackie, 2017).

The third narrative focuses on political economy and regulation. It argues that labour market institutions – such as collective bargaining and regulation on wages, working conditions and dismissals – have been weakened over the past three decades in most developed and many developing countries (Campos and Nugent, 2012; Storm, 2019a; Stansbury and Summers, 2020) with negative effects on wage growth. Some variants of this narrative also argue that stronger labour market institutions support wage growth by strengthening labour's bargaining power and social protection benefits as well as securing sustained growth of aggregate demand (Berg, 2015; Storm and Capaldo, 2018).

While researchers continue to debate the importance of each narrative, it is clear from existing studies and data that the causes of wage repression are complex. While technological innovation has certainly played a role, other factors have too both by directly affecting the labour market and by setting the pace of innovation. Therefore, micro and macroeconomic policies, including on trade and finance, do matter for income distribution. As discussed in chapter II, taking this fact into account is critical if globalization is to benefit most workers.

E. Sectoral and composition effects on average productivity

Average productivity is a composite quantity, itself shaped by both technological and political economic factors affecting productivity in each economic sector and each sector's expansion or contraction. To distinguish technological from political economic factors, average productivity growth can be decomposed into sectoral and reallocation components. This allows to determine the extent to which its growth rate depends on "within-sector" productivity growth – i.e. productivity growth in each sector assuming the sector's weight in the economy doesn't change – and on each sector's expansion relative to the rest of the economy.

For example, recent research suggests that software companies have experienced faster productivity growth but lower employment growth than other sectors, having a positive "sectoral" effect and a negative "composition" effect on average productivity (Storm, 2017a; Stansbury and Summers, 2020). Composition effects are especially important in developing countries where a highly diverse productive structure may allow quick productivity gains (or losses) as workers move between low and high productivity sectors (Lewis, 1954; Kuznets, 1971; McMillan et al., 2014; Rodrik, 2016). Business decisions on hiring and investment, as well as workers' willingness to engage in a long search for higher paying jobs, are factors shaped by policy.

Comparable data on production, employment and wages are compiled annually for a majority of countries, but only at the level of the three macro sectors of the economy – primary activities (agriculture and primary commodities extraction), industry and services. More disaggregated data are available for fewer countries. Thus, a useful analysis of productivity can start by looking at global trends emerging from a three-sector disaggregation then zooms in on the economies with richer data for more insights.

In table 3.2 total (or average) productivity growth since 1990 is disaggregated into the contributions of the three macro-sectors and reallocation effects. A sector's contribution to average productivity over a period of time is the sector's productivity growth weighted by its initial share of employment. Reallocation effects indicate how much average productivity has grown (or declined) due to reallocation of workers between sectors. A positive reallocation growth rate indicates that, on average, worker reallocation during a certain decade has increased productivity. A negative rate indicates that reallocation has, on average, decreased productivity. The economy's productivity growth is determined by the sum of sector-level contributions and reallocation effects. Primary activities include agriculture, both large-scale and small-scale, together with extractive activities such as mining. Industrial activities include manufacturing, civil construction (residential and non-residential) and public utilities. Services encompass both high-productivity activities as finance, insurance and real estate (the FIRE sector) and low-productivity activities as domestic services (the "care" or "servant" sector).[1]

Looking at developed countries, a first feature that emerges is a clustering of (total) labour productivity growth rates between 8 per cent and 13 per cent over the last decade, with two outliers: Italy's 2.9 per cent, which was a consequence of two decades of wage repression and fiscal austerity (Storm, 2019b; Halevi, 2019), and the Republic of Korea's 23 per cent. A second striking feature is a slowdown of total productivity growth everywhere compared to the 1990s. The Republic of Korea experienced especially fast productivity growth in the decades of deep structural transformation, when it established its industrial structure, and slower but still high growth as its rate of investment levelled off in the 2000s. A third striking feature is a slowdown of sectoral contributions to productivity growth since the 1990s, with a few exceptions: in Canada the service sector and, in Japan, both industry and services. Fourth, in the last decade reallocation effects have been very low or negative while services' contributions have mostly topped those of other macro-sectors. This means that job creation has mostly shifted toward lower-productivity sectors, but the service sector boosted total productivity growth.

The service sector's large contribution may reflect its large share of employment, which has topped 50 per cent average in developed countries since the early 1970s and has since continued to increase. Even controlling for further increases, the share is so large that small productivity improvements make a large contribution to the total.

Finally, with the exception of Canada, in all developed countries the long slowdown of productivity growth has been due more to within-sector productivity changes, than to reallocation effects, suggesting that an opportunity to revive productivity growth may lie in better reallocation.

These trends have led to a view of service sector expansion as a global strategy for growth and development. They have also led to calls for liberalization in the hope of maximizing the service sector's job-creation potential and possible ways to boost productivity (IMF, 2018; World Bank, 2016; Asian Development Bank, 2013). But in many cases, this has been unwarranted, on both methodological and empirical grounds (Box 3.1).

In developing countries, the disaggregation of productivity reveals a more diverse picture. Everywhere but in Mexico average labour productivity growth accelerated in the 2000s and everywhere but in Mexico and Indonesia it slowed down in the last decade. Reallocation effects

TABLE 3.2 **Sectoral and composition effects on labour productivity growth, G20 countries, 1990–2019**
(10-year percentage point changes)

A. Advanced economies		*1990–1999*	*2000–2009*	*2010–2019*
Australia	Agriculture	4.44	15.14	1.93
	Industry	4.59	1.84	2.94
	Services	14.17	11.26	8.94
	Reallocation	-0.73	-7.20	-2.70
	Total	22.46	21.05	11.11
Canada	Agriculture	6.59	6.02	1.53
	Industry	7.29	-1.96	2.43
	Services	7.69	6.38	8.52
	Reallocation	-3.18	-4.30	-1.88
	Total	18.38	6.14	10.59
Germany	Agriculture	1.18	3.37	0.59
	Industry	6.64	4.23	4.48
	Services	12.52	-3.01	4.01
	Reallocation	1.37	-1.42	-0.87
	Total	21.71	3.17	8.21
France	Agriculture	1.68	0.86	0.76
	Industry	3.22	0.11	3.14
	Services	10.18	0.73	6.16
	Reallocation	0.80	0.67	0.42
	Total	15.88	2.37	10.49
Italy	Agriculture	4.90	0.78	-0.12
	Industry	4.14	-1.92	2.57
	Services	8.36	-5.38	-0.25
	Reallocation	1.54	0.73	0.70
	Total	18.94	-5.79	2.90
Japan	Agriculture	2.24	0.24	0.35
	Industry	-0.82	3.35	2.41
	Services	8.89	0.75	5.99
	Reallocation	0.51	0.08	0.03
	Total	10.81	4.42	8.78
Republic of Korea	Agriculture	9.78	2.77	3.87
	Industry	34.93	17.59	9.27
	Services	19.82	11.45	11.61
	Reallocation	-0.64	-1.74	-1.23
	Total	63.89	30.07	23.52
United Kingdom	Agriculture	3.79	1.40	0.38
	Industry	9.77	1.71	3.05
	Services	16.07	5.24	5.02
	Reallocation	-0.04	0.17	-0.36
	Total	29.59	8.52	8.09
United States	Agriculture	1.77	2.83	-0.53
	Industry	4.59	3.24	1.45
	Services	16.70	10.54	11.62
	Reallocation	-0.83	0.32	-0.03
	Total	22.23	16.92	12.50

B. Emerging market economies		*1990–1999*	*2000–2009*	*2010–2019*
Argentina	Agriculture	-5.78	-0.19	9.83
	Industry	10.37	10.90	-6.66
	Services	20.87	12.78	-1.14
	Reallocation	6.57	8.56	-13.29
	Total	32.03	32.05	-11.26
Brazil	Agriculture	-0.39	6.39	4.82
	Industry	-10.51	0.93	-2.31
	Services	7.97	6.96	-4.51
	Reallocation	4.19	2.19	0.51
	Total	1.26	16.46	-1.50
China	Agriculture	34.38	56.12	26.85
	Industry	48.00	55.81	40.87
	Services	25.55	34.08	33.59
	Reallocation	22.84	15.39	-2.25
	Total	130.77	161.39	99.05
India	Agriculture	8.17	16.79	20.61
	Industry	5.95	9.48	6.79
	Services	19.96	27.00	18.00
	Reallocation	6.97	13.07	17.24
	Total	41.05	66.34	62.64
Indonesia	Agriculture	10.63	13.25	19.03
	Industry	3.94	9.46	6.43
	Services	-5.76	5.95	14.19
	Reallocation	7.60	3.78	4.55
	Total	16.41	32.44	44.21
Mexico	Agriculture	1.36	3.28	-0.56
	Industry	8.23	-2.26	0.05
	Services	-3.04	-8.22	1.64
	Reallocation	4.17	0.35	0.20
	Total	10.73	-6.85	1.34
Russian Federation	Agriculture	-16.01	28.89	3.19
	Industry	-4.72	1.84	2.91
	Services	-0.12	23.37	4.85
	Reallocation	0.41	-12.02	-1.57
	Total	-20.44	42.08	9.38
Turkey	Agriculture	7.09	14.09	2.65
	Industry	-5.36	2.38	9.36
	Services	13.86	6.84	6.30
	Reallocation	13.65	9.46	4.02
	Total	29.24	32.77	22.34
Saudi Arabia	Agriculture	26.82	53.14	-28.04
	Industry	8.04	6.14	-1.90
	Services	-0.85	16.33	4.61
	Reallocation	-14.95	-26.96	5.17
	Total	19.06	48.66	-20.15
South Africa	Agriculture	-1.56	50.30	-1.67
	Industry	-1.60	2.93	0.07
	Services	15.28	9.71	3.01
	Reallocation	0.66	-29.85	1.03
	Total	12.78	33.09	2.44

Source: UNCTAD secretariat calculations based on United Nations Global Policy Model.
Note: Economy-wide (total) labour productivity is calculated as value added per worker. It is not to be confused with "total factor productivity", an average of labour and capital productivities.

have been large on average compared to developed countries, reflecting the structural transformations developing countries have undergone. However, in some cases – including China in the last decade and the Russian Federation – reallocation has been negative indicating that job creation in lower productivity sectors has outpaced job creation in more productive ones.

Beyond data decompositions, a critical issue is understanding and leveraging the prime causes of productivity growth. While these are complex and continue to be debated (Setterfield, 2014), data clearly indicate that productivity growth accelerates when economic activity accelerates (Kaldor, 1996; Targetti, 2005; Storm, 2017b). Thus, when an economy stagnates, sooner or later productivity growth slows down too. By the same token, in a fast-growing economy productivity is likely to pick up and drive down unit labour costs, making the economy more competitive. Employment will likely expand too, although at a lower rate than output (as implied by the increase in productivity) driving up real wages. Depending on labour market institutions and workers' bargaining power real wage growth may outpace or be outpaced by productivity growth. If real wages and productivity grow at the same rate, the labour income share remains unchanged.

BOX 3.1 Rent-seeking services

The shares of the services sector in both total value added and employment have grown considerably over the past few decades, not only in developed economies, where this has been a normal feature of long-term structural change, but also in many developing countries, where it has occurred at much earlier stages of industrialization and structural transformation. Therefore, the question arises as to whether developing economies can leapfrog to more advanced stages of industrial development by relying to a greater extent on services in structural transformation, and by shifting employment and income creation from activities in the primary sector directly to the tertiary sector (Ghani and O'Connell, 2014; IMF, 2018).

Interest in the possibility of services-led growth may also result from the fact that export-led industrialization is becoming more difficult, as an ever increasing number of producers from developing countries compete in a global market that is expanding much more slowly than when countries, such as the so-called four East Asian tigers, successfully embarked on export-oriented industrialization. There is, however, little evidence that the highly heterogeneous service sector, by itself, can play the role of engine of growth without a strong manufacturing base or at least strong linkages with complementary industrial activities. The example of middle-income developing countries where tourism is a major source of foreign exchange earnings is a case in point (Arezki et al., 2009). Some modern services, such as those enabled by information and communications technologies (ICTs), can have positive impacts on structural transformation similar to those that traditionally have been ascribed to manufacturing in terms of productivity and employment growth and linkage creation, including through international trade (Dasgupta and Singh, 2005; Saez et al., 2015). However, these knowledge-intensive business services tend to be concentrated in densely populated areas and require large markets where increasing returns to scale, skills agglomeration and strong spillover effects are already present (Cherif and Hasanov, 2019).

The wider point is that services embrace a very broad range of distinct activities, from mostly non-tradeable "low-skilled" and low-productivity consumer services to tradeable "high-skilled" financial and business services. Optimistic views on the potential of the services sector to replace, to a significant extent, the manufacturing sector as a driver of a dynamic process of structural transformation often rely on anecdotal sectoral evidence in select developing countries (such as Hong Kong, China)[2] and on the evolution of productivity in developed countries over the past few decades (Bosworth and Triplett, 2007; Inklaar and Timmer, 2008). However, such studies need to be considered with caution. First, the increasing importance of services as a share of total employment could partly result from a statistical illusion (Andreoni and Gregory, 2013; UNIDO, 2013), since various activities, ranging from design and data processing to transport, cleaning and security, are increasingly contracted out by manufacturing firms to specialist service providers, so that the boundaries between services and manufacturing activities have changed over time (Di Meglio et al., 2015). Such services are not new to economies, but external provision by specialized service firms implies an accelerated expansion of the services sector and a deceleration of value-added growth in manufacturing. More importantly, the expansion and upgrading of such services are largely dependent on the expansion and upgrading of the manufacturing activities they relate to.

Second, the heterogeneity of the tertiary sector implies that the ability of different kinds of services to boost productivity varies widely (Timmer et al., 2014). In most countries, productivity is significantly higher in

"finance, insurance, real estate and business services" and in "transport, storage and communications" than in other categories. The first category involves activities whose value added is significantly affected by price changes that are hard to represent realistically as "productivity" changes, while the second includes activities that have been progressively outsourced by manufacturing firms. Productivity levels in other categories such as "trade, restaurants and hotels", "community, social and personal services" and "government services" are, in general, much lower.

Moreover, the services sector has long been characterized as suffering from a cost disease (Baumol and Bowen, 1966), whereby its growing share in national income is as much a consequence of rising prices as expanding output, which in turn reflects the inherent constraints on raising productivity in service activities. In this context, many activities classified as high-productivity, such as financial services, are better understood as "high-rent" services. As discussed in previous *Reports*, rents (and rent-seeking) are essentially generated from a combination of resource (or asset) scarcity and market power to transfer existing income.

Economists mostly agree that, by and large, rents are unproductive, wasteful and potentially damaging. Yet, as their output is measured by the price charged for the service provided, they can give the impression that for those generating them their activity is highly productive. This is particularly true of financial services, which are habitually classified as high-productivity because the income of the (relatively) small number of people working in the sector are often very high, leading Tobin (1984) to note that these kind of activities "generate high private rewards disproportionate to their social productivity". Since then rent-seeking has become a much more ubiquitous feature of income distribution and a major source of rising inequality.

Still, the composition of the services sector can matter in terms of its contribution to employment and productivity growth. For example, low-wage services such as hospitality and personal care, may help to create employment for surplus labour, even if the registered gains in terms of overall productivity are low. However, improving the quality of these services and raising their wages, many of which, as a consequence of Covid-19, have been designated essential, would raise their measured productivity and in all likelihood raise productivity in more traditional activities. The bigger point is that many service activities have not emerged sui generis, but as an offshoot of manufacturing activities, and at the same time they may contribute significantly to productivity growth in those manufacturing activities. Improving the quality of services is also essential, because qualitative improvements can fundamentally change the nature, the market and the development potential of the services on offer. Of course, by cutting costs in some service activities through innovation and productivity growth (not those that rely more on the human element), the services sector can also stimulate technological progress.

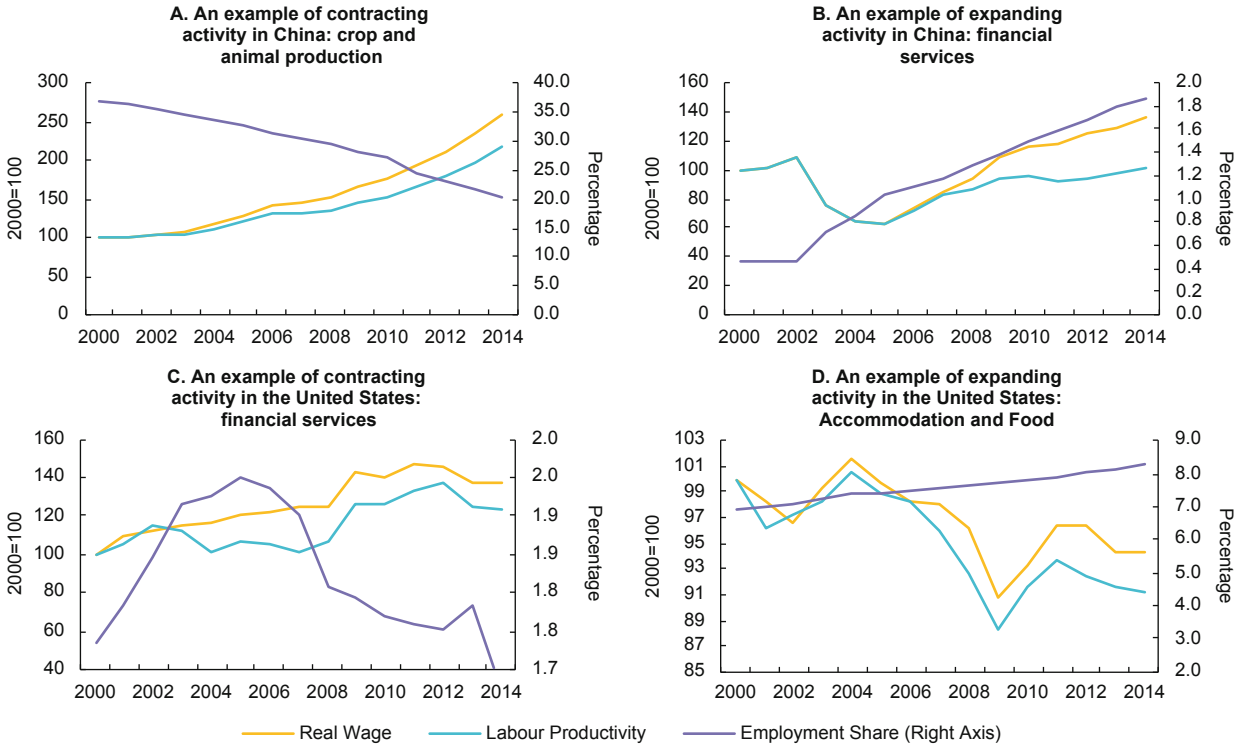
F. Polarization

As is apparent from the previous discussion, shifting employment shares across sectors affect total labour productivity growth. In many developing countries, for example, productivity has increased as workers have moved from agriculture to industry. But what happens to productivity when, at later stages of development, workers move from industry to services is less clear-cut. To detect these changes data on the three macro-sectors are not enough and more detailed information is necessary. While this is not available for recent years, existing data are still useful to detect structural trends that may affect the fallout of the present crisis and the prospects for recovery.

Disaggregated data from input-output tables indicates that, in fast-developing economies, agriculture's employment share decreased until 2014 while the shares of most of all other sectors increased (see annex to chapter III). For example, in China, agriculture's employment share plummeted between 2000 and 2014, while the shares of both industry and services increased. Productivity and wages in the shrinking sector increased markedly (figure 3.4A), confirming that workers in agriculture were frequently under-employed. In expanding sectors productivity and wages also increased as labour demand expanded fast (figure 3.4B) and employers invest in labour-saving technologies.

The United States provides a contrasting example. During the same period, agriculture's employment share in the United States did not change while jobs moved from industry to services (see annex to chapter III). But jobs have also moved within the service sector between different activities. Predictably, for activities whose employment share decreased productivity and wages have increased, as has been the case for financial services (figure 3.4C). But in

FIGURE 3.4 **Examples of contracting and expanding activity in China and the United States, selected sectors, 2000–2014**


A. An example of contracting activity in China: crop and animal production
B. An example of expanding activity in China: financial services
C. An example of contracting activity in the United States: financial services
D. An example of expanding activity in the United States: Accommodation and Food
2000=100
Percentage
Real Wage
Labour Productivity
Employment Share (Right Axis)

Source: UNCTAD secretariat calculations based on *World Input-Output Database*.

many employment-expanding sectors the policies and institutional factors mentioned in the previous two sections have led to decreasing productivity and wages (figure 3.4D).

As recent research indicates (Storm, 2017a; Taylor and Ömer, 2020), job creation in high-wage, high-productivity activities has slowed down, following a slowdown of demand. Job seekers, pressured to find employment in the absence of a comprehensive social protection system, have therefore turned to lower wage, lower productivity activities, such as accommodation and food services. Without binding minimum wage laws, this has slowed down or reversed real wage growth for these activities even more, giving rise to a growing class of impoverished workers and further slowing down domestic demand growth. Institutional and policy choices have driven a wedge into the labour market that has split the economy creating job polarization.

This pattern is found in some developing countries too where declining industrial employment as a share of total employment has coincided with a declining share of wages in total income and weakening productivity growth (see Box 3.2). The result has been stalled industrialization or "premature deindustrialization" and growing economic and social imbalances (*TDR 2016*). Moreover, these trends have, in many cases been further compounded by a toxic combination of fiscal austerity, trade liberalization and gender segregation (*TDR 2017*, chap. IV), whereby women have been systematically excluded from access to (a diminishing number of) good industrial jobs, lowering labour's share of income with negative knock-on effects on aggregate demand and ultimately growth.

BOX 3.2 **Dual labour markets and productivity growth**

Theories of dual or segmented labour markets posit the existence of technologically and institutionally distinct labour markets, distinguished by different wage-setting mechanisms and conditions of work, barriers to mobility between the labour markets and rationing of access to jobs in the privileged (or core) sector. Dual labour markets can include tough barriers between them, with institutional practices and social norms making it difficult to move from the peripheral to the core sector (Das, 2013).

Jobs in the core sector are highly coveted. These jobs are more likely to be in the formal sector of the economy where firms offer higher wages, various benefits, greater job security, opportunities for job upgrading and better regulated working conditions. Firms in the core sector often have market power, generating rents that can be shared with workers, and they can offer higher wages relative to those in the peripheral sector. Higher profitability also enables more investment, boosting productivity and further increasing the gap between workers in the core and peripheral sectors (Gordon et al., 1982).

In contrast, jobs in the peripheral labour market are more insecure, intermittent and generally dead-end propositions, with fewer opportunities for on-the-job training and upward mobility. Firms in the peripheral sector tend to have little market power and thin profit margins, which inhibit the sorts of investments that raise productivity and wages. The peripheral labour market in developing countries is comprised largely of informal service sector jobs, as well as agriculture and small-scale, often informal, manufacturing (Vanek et al., 2014).

The availability of, and thus access to, good jobs in the core sector depends first and foremost on the structure of an economy. The processes of development linked to industrialization, where economies of scale and scope promote more rapid productivity growth, also hold promise for expanding opportunities in core sectors. While industrial policies can facilitate structural change, macroeconomic conditions also help determine the availability of jobs in the core sector, including the level of demand and a country's trade and investment relations with the rest of the world. In recent years, patterns of stalled industrialization or premature deindustrialization have been observed in a number of developing countries, thus limiting the growth of industrial sector jobs (*TDR 2016*).

In most trajectories of productivity-enhancing structural change and development, the processes of industrialization and the shifting of resources – including labour – into higher productivity sectors support aggregate productivity growth. However, it is through the expansion of higher productivity work in the modernizing, increasingly diversified industrial sector that labour initially accesses the higher incomes that accompany industrialization and development, ultimately building domestic aggregate demand and sustaining aggregate productivity growth. (In this sense, for growth to be sustained it must also be inclusive.) When these connections fail to materialize, or weaken, stalled or premature (de)industrialization dampens the prospects for inclusive development.

Higher value-added, knowledge-intensive services, which account for a more substantial share of employment than industry in developed countries, have recently been emphasized as an alternative to the lacklustre job-generating performance of industry in developing countries. However, in developing countries, in particular, the services sector alone is not likely to provide a sufficient alternative to industry for the generation of core jobs, especially if it is disconnected from a dynamic industrial sector (Roncolato and Kucera, 2014; *TDR 2016*). Relative to the industrial sector, jobs in the services sector are more likely to be informal and insecure, with lower productivity and thus lower wages, especially for women. They most probably reflect the growth of low-productivity (often traditional) services rather than the beginnings of long-term dynamism − a type of disguised unemployment that ultimately reflects the failure of growth to generate enough decent work. Accounts of the links between globalization and informalization echo these problematic dynamics (Bacchetta et al., 2009).

Measures of decent work, as defined by ILO, provide a good basis for comparing the quality of employment in services and industry. Decent work is defined as work that is productive, has workplace protections, and offers social protection and prospects for individual development (such as skills upgrading). In the absence of an international dataset on decent work opportunities by sector, a measure of relative job quality can be calculated using the ratio of labour productivity in the services sector to that in the industrial sector. The rationale for this comparison is that higher productivity measures are associated with greater remuneration and benefits. This is not the same as saying that industrial workers are more "productive" than services sector workers.

Trying to measure services sector productivity is controversial, partly because of the difficulty in measuring outputs. Indeed, for the services sector at least, productivity measures can be thought of more as a consequence of wages than a cause. Hence, higher relative productivity in developed countries in this sector partly reflects higher per capita incomes. Regardless, lower productivity measures indicate lower wages. Among developing regions, to varying degrees, labour productivity in the services sector is lower than in the industrial sector (thus the productivity ratio between the two sectors is smaller than 1). The median ratio for all non-developed regions is close to 0.75, suggesting that average productivity is roughly 25 per cent lower in the services sector than in the industrial sector.

Source: based on *TDR 2017*.

G. Income distribution after Covid-19: Prospects and policies

While it is too early to fully assess the job losses caused by the pandemic globally (ILO, 2020b), it is clear that jobs in some sectors are more vulnerable to business lockdowns, and the consequent loss of demand, than others. At a minimum, these include jobs in accommodation and food services, retail, air transport and "other services" (such as security and other services ancillary to retail), which in 2014 absorbed 15 per cent of employment globally, up from 13 per cent in 2000. Since 2014 this proportion has likely increased because of polarization in advanced countries and employment reallocation to services in developing countries.

Behind the average, countries differ greatly with developed countries featuring a higher proportion of newly vulnerable jobs than developing countries, given that informality has long been the norm in the latter. Countries also differ in their response to the job losses, with some countries (predominantly advanced) providing temporary replacement income through regular and emergency unemployment insurance and some providing little or no income. Higher informality in developing countries makes the proportion of jobs vulnerable during the Covid-19 lockdown especially high and the likelihood of receiving replacement income especially low.

With global employment estimated at 3.3 billion workers in 2019, including an estimated 60 per cent of informal employment (ILO, 2020a), and assuming that the share of vulnerable service sector jobs is the same for formal and informal employment and has not increased since 2014, the short term job loss caused by the pandemic globally can be estimated at 495 million jobs. The implied increase in the global unemployment rate of 15 percentage points is a daunting figure, especially when faced by 200 uncoordinated national policies, many of which are tightly constrained by fiscal limits and the rules of hyperglobalization (*TDR 2017*; *TDR 2018*). Yet country differences indicate that actual job losses are larger and experience from the GFC suggests that the longer-term toll on employment, incomes, financial balances and ultimately growth and development can be heavy (Oulton and Sebastiá-Barriel, 2016).

These massive numbers imply misery and hardship, likely leading to a protracted slowdown of demand, real wages and productivity growth, all in a spiral of growing inequality and enduring stagnation. From the analysis in this and previous chapters, it is clear that, even when the Covid-19 crisis subsides, the global economy's core vulnerabilities will remain, and slow the recovery.

These challenges call for a shift in approach to policymaking, putting full employment and real wage growth at the centre of both macroeconomic and sectoral policies. First, public work programmes and employer-of-last resort programmes have a fundamental role to play to secure household incomes while improving ailing infrastructures and public services (Tcherneva, 2020). Secondly, cash transfers such as universal basic income are also important to sustain demand and reduce inequality, especially in developing countries. Third, fiscal and monetary policies should target full employment. While this is already the case in some developed and developing economies, fiscal austerity continues to repress aggregate demand in many countries (chapter IV) while the limits of monetary policy as an expansionary instrument have become evident after a decade of record credit creation (chapter I).

As discussed in last year's *Report*, returning to the higher wage shares of the mid-1990s – hardly an ambitious target – can be achieved through labour market regulation that supports employees compensation while limiting profit mark-ups. Raising minimum wages, strengthening collective bargaining institutions and increasing employers' social security contributions are obvious instruments. While such measures will need to be tailored to national circumstances, increases in the labour income share will drive up GDP growth mainly by supporting household spending and, indirectly, business investment. However, some degree of international coordination will also be critical to induce all countries to adopt the necessary policies (chapter V).

But full employment is not sufficient to eliminate job polarization and the instability it generates. As discussed above, countries can experience fast job creation in many sectors while not distributing enough income for a sustainable growth of demand and productivity. Therefore, governments must liberate industrial policy from its constraints – and in

both developed and developing countries – in order to expand employment in high-productivity activities and make sure that investment in strategic sectors, including those instrumental to the green transition, takes place at necessary rates (*TDR 2016*; *TDR 2019*). Trade policy must also favour this effort by encouraging competition at the higher end of the productivity ladder rather than being a weapon aimed at labour's bargaining power (*TDR 2018*).

With respect to both trade and industrial policies needed to sustain recovery, coordination with macroeconomic policy making is crucial. As Rodrik (2018) notes, governments that seek to promote structural shifts into higher productivity activities, need to adopt policies that will ensure high levels of aggregate demand, high levels of investment and a stable exchange rate. Macroeconomic and financial policies that work against these goals will not be compensated by more active industrial policies, indeed will likely undermine such policies (Zalk, 2015).

While fiscal policy is clearly important to maintain an expansionary economic environment in which economic diversification and upgrading can take place, public investment is also the major source of infrastructure spending in most countries, both developed and developing. Such investment is particularly important in the latter, if higher value-added activities are to flourish. As discussed further in the next chapter, fiscal austerity, regardless of economic context, is destructive, not just for short-term activity but also for structural transformation, since it tends to limit public investment.

Employment and real wages will have to rise significantly to correct the distributional imbalances that have built up under hyperglobalization, but building more inclusive economies post-Covid-19 will also require directly tackling various forms of discrimination, including by race and gender, that continue to segment societies and have a detrimental impact on future development prospects. Combating workplace stereotypes and otherwise fostering and facilitating access to core sector employment, especially through social infrastructure investments that better enable women to combine paid work and their responsibilities for care, will need to be directly addressed.

The question of care work, in particular, should become an integral part of any policy agenda for recovering better (UNWomen, 2020). Women's primary responsibility for this kind of work is an ongoing source of gender inequality. However, given the employment challenges post-Covid-19, part of gender inclusion for growth and development must be about transforming paid care work into decent work with the wage levels, benefits and security typically associated with industrial jobs in the core sector of the labour market. This is a challenging prospect for most economists to consider, as social services (of which care work constitutes a large part) – whether provided within or outside markets, or by the public or private sectors – are treated more as consumption goods than investments in the future. Moreover, they are systematically undervalued (and underpaid) largely because they are considered to be women's work. What investing in the care sector means in economic terms, and at different levels of development, is thus not well understood in relation to some of the longer-term policy challenges, such as raising aggregate productivity, structural transformation and technological change, discussed in this chapter. But the questions themselves need to become a more standard feature of growth analytics, rather than treated as special topics on care, if gender inclusion is to be incorporated into the overall economic system rather than treated as an outcome that requires some sort of ex post facto inequality "fix".

More generally, for proactive social policy to be transformational, it must go beyond offering simply a residual category of safety nets or floors designed to pick up (or stop falling) those left behind. The mere fact of providing some degree of social protection or welfare to those in greatest need does not make society more inclusive, if anything the opposite; evidence suggests that social policies which are designed and targeted to help the poorest or the most needy are typically less inclusive than those that are universal. This conclusion appears to be confirmed by the unequal health (and mortality) impact of Covid-19 (van Dorn et al., 2020). Finally, effectively designed social policies can also be used to accelerate and manage structural transformation, helping to foster technological upgrading and productivity gains (Ringen et al., 2011; Sandbu, 2020), underscoring the importance of an integrated approach to policy making for recovering better.

The policies necessary to generate a recovery and make sure it leads to sustainable growth and development are the components of a Global Green New Deal (*TDR 2019*). As a policy programme to revive and rebalance the global economy, this strategy would also help establish economic security and generate overall resilience in the face of macroeconomic

shocks. As the global economy ventures into an uncharted territory amid economic, financial and environmental tensions, this programme offers a path to security.

Notes

1 See also Piketty (2020), Milanovic (2018), Stiglitz (2013), Galbraith (2012).

2 In National Accounts FIRE's output, on which the productivity metric is based, is imputed from the incomes of workers and businesses operating in the sector. This makes FIRE's output and productivity less reliable as measures of economic activity, compared to economic sectors where output is calculated on the basis of physical production (Foley, 2011).

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Annex: Hunting for polarization

A richer picture on job and income polarization can be obtained from the World Input-Output Database (WIOD). It provides annual data for the period 2000–2014, sufficient to identify dual or multi-speed development with some sectors exhibiting faster productivity growth than others before and after the GFC. The focus here is on China and the United States.

Extending the framework presented in table 3.2, tables 3.A.1 and 3.A.2 present a decomposition of labour productivity growth into 10 sectors indicating sector-level contributions and reallocation effects. The tables compare cumulative productivity growth (and their components) over two 5-year periods: 2000–2005 and 2009–2014. These were both periods of post-crisis recovery, following the bursting of the dotcom and subprime mortgage bubbles, respectively. Thus, these tables provide an indication of how structural economic features may or may not have changed since the beginning of the century. Sectors' selection is based on recent analyses of how productivity dynamics may create economic dualism (Storm, 2017a, 2019b).

In the United States, total productivity growth grew 12.5 per cent in 2000–2005 (table 3.A.1). The first column of table 3.A.1 indicates that productivity grew particularly fast in the primary sector, *PRIMARY*, (59 per cent), followed by professional and business services, *PBS*, information, *INFO*, and manufacturing, *MFG*. *MFG* exhibited the fourth highest productivity growth. But these growth rates only consider each sector individually. To appreciate their contribution to economy-wide productivity growth, the size of each sector and its changes – measured by the changes in the share of total employment they absorb – have to be taken into account. The fourth column of table 3.A.1 shows that between 2000 and 2005 employment in the *PRIMARY, MFG*, *INFO, PBS*; and wholesale, retail and transport, *WRT* increased less than in the rest of the economy, *REST* – these sectors' employment shares actually fell – while finance, insurance and real estate, *FIRE*; utilities and construction, *UC*, education, health and social services, *EHS*, *REST* and the government, *GOV*, absorbed a higher share of employment. The largest contraction happened in *MFG* and the largest expansion in EHS, a relatively low wage, low productivity activity.

Taking into account the employment share of each sector and controlling for its changes gives the sector's own contribution to economy-wide productivity growth. Every sector that has experienced positive productivity growth makes a positive contribution, with the size of the contribution depending on the sector's relative productivity level. Thus, MFG sectoral contribution turns out to be the largest, followed by *FIRE* and *PBS*. While *MFG* featured a lower employment share and a lower sector-level productivity growth than *PBS*, its productivity level was much larger. The same reason explains the relatively low contribution of *EHS* despite a large employment share: its productivity was very low in 2000 and did not grow fast in the 2000–2005 period.

Switching perspective, reallocation effects measure how much a sector has contributed to economy-wide productivity growth only by absorbing workers from other sectors. Thus, every sector whose employment share has increased makes a positive contribution and every sector whose share has decreased makes a negative contribution (driving down the average). But, as for sectoral contributions, the size of the effect depends on the sector's productivity level. This explains why *MFG* reallocation effect is negative and by far the largest. Given the sector's large contribution to the average productivity level, the contraction of its employment share during the 2000-2005 period drove down average productivity more than 3 per cent, outweighing its positive sectoral contribution and making manufacturing the only sector's whose total contribution to average productivity growth was negative. Table 3.A.1 tells us that if *MFG* employment share had not contracted, average productivity growth in the period 2000–2005 would have been 3 percentage points higher. The contrast with *FIRE* contribution is stark. *FIRE* sectoral contribution and reallocation effect cooperated to push economy-wide productivity up by a total of 3.4 percentage points, or more than 27 per cent of the total increase of 12.5 per cent.

As is clear from table 3.A.1, the 12.5 per cent increase of economy-wide labour productivity in the period 2000–2005 resulted from positive sectoral contributions that increased it 13.6 percentage points and negative reallocation effects that pushed it down 1.1 percentage points. Furthermore, more than a third

TABLE 3.A.1 Shift-share decomposition of productivity growth, United States, 2000–2005 and 2009–2014

	Productivity		*Employment Share*			*Contributions*		
	2000	*2000–2005*	*2000*	*2005*	*Diff*	*Section*	*Reallocation*	*Total*
	USD	*Per cent*	*Per cent*	*Per cent*	*Per cent*	*Per cent*	*Per cent*	*Per cent*
Total	**84'158**	**12.533**	**1.000**	**1.000**	**0.000**	**13.582**	**-1.049**	**12.533**
PRIMARY	90'039	59.260	0.019	0.018	-0.001	1.204	-0.183	1.021
MFG	107'426	17.632	0.119	0.098	-0.021	2.689	-3.154	-0.465
INFO	126'619	18.892	0.038	0.037	-0.001	1.076	-0.098	0.978
FIRE	274'525	13.354	0.055	0.058	0.003	2.410	0.993	3.402
PBS	64'292	18.934	0.141	0.134	-0.007	2.040	-0.613	1.427
WRT	73'812	7.864	0.187	0.186	-0.001	1.293	-0.108	1.185
UC	86'143	9.752	0.064	0.068	0.005	0.634	0.508	1.142
EHS	50'586	10.987	0.110	0.122	0.012	0.728	0.810	1.538
REST	42'704	1.337	0.113	0.118	0.006	0.076	0.303	0.379
GOV	70'828	11.086	0.154	0.159	0.005	1.432	0.494	1.927
	2009	*2009–2014*	*2009*	*2014*	*Diff*	*Section*	*Reallocation*	*Total*
Total	**98'622**	**4.682**	**1.000**	**1.000**	**0.000**	**5.765**	**-1.083**	**4.682**
PRIMARY	158'364	27.626	0.018	0.020	0.001	0.820	0.249	1.070
MFG	140'096	8.048	0.085	0.083	-0.002	0.973	-0.275	0.698
INFO	169'061	-0.750	0.036	0.038	0.002	-0.046	0.385	0.339
FIRE	330'127	10.922	0.056	0.053	-0.003	2.053	-1.043	1.009
PBS	83'070	-0.556	0.132	0.141	0.008	-0.062	0.698	0.636
WRT	79'991	8.387	0.182	0.180	-0.002	1.238	-0.183	1.055
UC	98'645	6.022	0.060	0.056	-0.004	0.361	-0.402	-0.040
EHS	59'846	-3.261	0.139	0.146	0.007	-0.275	0.421	0.147
REST	43'002	3.307	0.122	0.127	0.004	0.177	0.193	0.370
GOV	83'709	3.666	0.169	0.156	-0.013	0.525	-1.127	-0.601

Source: UNCTAD secretariat calculations based on *World Input-Output Database*.
Note: EHS: education, health and social services.
FIRE: finance, insurance and real estate.
GOV: government.
INFO: information.
MFG: manufacturing.
PBS: professional and business services.
PRIMARY: primary sector.
REST: rest of the economy.
UC: utilities and construction.
WRT: wholesale, retail and transport.

of the economy's productivity growth depended on two sectors alone – *FIRE* and *INFO*. Another 26 per cent depended on *EHS*, *PBS* and *REST*, all low-productivity sectors, while 15 per cent depended on *GOV*. Overall, 75 per cent of productivity growth depended on six very different sectors.

The productivity performance in the United States was markedly different in the 2009–2014 quinquennium. Economy-wide productivity growth dropped 7 percentage points to 4.6 per cent. In the private sector, *MFG*, *FIRE*, *UC* and *WRT* lost employment shares, which were largely absorbed by *PBS* and *EHS*, both low productivity sectors. While *FIRE* and *INFO* continued to sustain almost a third of average productivity growth, the contribution of *EHS* and *REST* dropped from 15 per cent in the period 2000–2005 to 10 per cent in 2009–2014. This is a clear sign of polarization: while average productivity increasingly relies on high productivity (and high wage) sectors, these lose employment shares to low productivity (low wage) sectors. Wage repression in many sectors drives down economywide productivity undermining aggregate demand and slowing down growth, ultimately reinforcing the reallocation of employment in a vicious circle. It is clear that these unsustainable trends will not be reversed unless appropriate policies stop and reverse wage repression.

TABLE 3.A.2 Shift-share decomposition of productivity growth, China, 2000–2005 and 2009–2014

	Productivity		*Employment Share*			*Contributions*		
	2000	*2000–2005*	*2000*	*2005*	*Diff*	*Section*	*Reallocation*	*Total*
	RMB	*Per cent*	*Per cent*	*Per cent*	*Per cent*	*Per cent*	*Per cent*	*Per cent*
Total	**20'778**	**50.821**	**1.000**	**1.000**	**0.000**	**36.448**	**14.374**	**50.821**
PRIMARY	8'836	54.723	0.475	0.406	-0.069	11.055	-4.558	6.497
MFG	43'600	47.922	0.153	0.158	0.005	15.425	1.415	16.840
INFO & PBS	85'903	4.976	0.010	0.021	0.012	0.196	5.082	5.278
FIRE	261'985	-50.694	0.007	0.019	0.013	-4.208	7.816	3.608
WRT	28'812	15.255	0.103	0.124	0.021	2.172	3.418	5.590
UC	26'260	83.642	0.068	0.060	-0.008	7.184	-1.778	5.407
EHS	12'772	88.960	0.074	0.063	-0.011	4.049	-1.324	2.725
REST	9'852	36.251	0.094	0.110	0.016	1.611	1.023	2.634
GOV	43'260	-29.286	0.017	0.039	0.022	-1.037	3.280	2.242
	2009	*2009-2014*	*2009*	*2014*	*Diff*	*Section*	*Reallocation*	*Total*
Total	**46'420**	**38.897**	**1.000**	**1.000**	**0.000**	**31.837**	**7.060**	**38.897**
PRIMARY	20'465	81.536	0.346	0.261	-0.085	12.426	-6.816	5.610
MFG	78'782	23.525	0.190	0.196	0.006	7.599	1.202	8.801
INFO & PBS	117'672	25.563	0.024	0.029	0.005	1.579	1.596	3.175
FIRE	182'415	21.136	0.027	0.034	0.007	2.258	3.368	5.626
WRT	54'497	21.105	0.113	0.140	0.027	2.799	3.862	6.661
UC	54'390	23.489	0.077	0.087	0.010	2.122	1.496	3.618
EHS	31'021	28.272	0.068	0.083	0.015	1.291	1.256	2.547
REST	18'830	27.221	0.106	0.115	0.009	1.167	0.478	1.645
GOV	42'713	13.401	0.048	0.054	0.006	0.596	0.618	1.214

Source: See table 3.A.1.
Note: See table 3.A.1. Owing to data limitations, INFO and PBS are presented jointly.

In China in the period 2000–2005 several sectors saw a decline in employment shares, especially *PRIMARY*, a common sign of industrialization. However, *UC* and *EHS* contracted too, by approximately 1 per cent each. Compared to the United States, China's sector-level productivity growth rates were large, leading to large sectoral contributions. *MFG*, in particular raised average productivity more than 15 percentage points, almost half the total sectoral contribution (of 36 percent growth) and almost one third of the total. Differently from the United States, *FIRE* productivity growth and its sectoral contributions were negative, decreasing average productivity growth 4 percentage points. Overall, sectoral contributions in China were almost three times larger than in the United States and reallocation effects were almost 14 times larger, a sign that the Chinese economy was undergoing deep structural transformation.

Data for the period 2009–2014 paint a different picture. Economy-wide productivity growth slowed down almost 12 percentage points compared to 2000–2005, mostly owing to reduced contributions by manufacturing, *UC* and *INFO & PBS*. The bright spots were *FIRE* and *WRT*, the only two sectors whose contributions to average productivity increased compared to 2000–2005.

Overall, sectoral contributions in China in 2009–2014 decreased, mostly due to plummeting contributions by *MFG* and *UC*, but remained high. By contrast, reallocation effects dropped by half their 2000–2005 level to 7 per cent. This was mostly due to *FIRE* and *INFO & PBS* whose employment shares increased less in 2009–2004 than in 2000–2005. Their combined reallocation effect was less than 5 percentage points in 2009–2014, compared to almost 13 percentage points in 2000–2005. In relative terms, their reallocation effects also dropped dramatically, from 25 per cent of average productivity growth in 2000–2005 to 12.7 per cent in 2009–2014.

When all sectoral contributions and reallocation effects are taken into account, China's economy does not show signs of polarization in the way the United States economy does. With primary activities ceding

employment share to all other sectors, there is no transfer of jobs from high productivity to low productivity activities. But there are warning signs. In the five years after the outbreak of the GFC productivity growth was more reliant on *FIRE* and *WRT* than in 2000–2005. In 2009–2014 *FIRE* contributed 11 per cent of average productivity growth, up from just 4 per cent in 2000–2005. By contrast, *MFG* and *UC* contributed only 24 per cent of average productivity growth in the latter period, compared to 43 per cent in the former. These numbers suggest that the economy shifted gears in 2009–2014 toward a structure more reliant on finance without a corresponding increase in financial sector employment. Polarization may be nascent after all. Whether it picks up speed depends largely on how policymakers manage the distributional consequences of this sectoral shift.

RECOVERING BETTER: EXPANDING THE SPACE FOR FISCAL POLICY

IV

A. Introduction

The expressed desire to recover better from the Covid-19 crisis is not only haunted by the ghosts of the GFC but by the longer history of a concept responsible for much needless suffering. What Blyth (2015) has termed the "dangerous idea" of austerity – often accompanied by its close ideological cousin "the confidence fairy" (Krugman, 2015) – has been the default policy response to economic crises since, at least, the late 19th century. There was a paradigm shift following the Great Depression of the early 1930s, but both these ideas have taken on greater importance in the era of hyperglobalization, given the dominant role of footloose capital and deregulated financial markets, crowding out Keynesian ideas of demand management.

Central to that consensus is the idea that by curtailing the fiscal space available to governments, macroeconomic imbalances, both domestic (fiscal deficits) and external (payments deficits) can be contained. This step, it is claimed, avoids damage to private investment, restarting growth on a more stable footing, and injecting confidence into the business sector.

It is often forgotten that the iteration of this policy consensus that seized the advanced economies in the last decade underwent its first clinical trials during the "lost decade" of the 1980s in the developing world. The prescription was straightforward "minimize fiscal deficits, minimize inflation, minimize tariffs, maximize privatization, maximize liberalization of finance" (World Bank, 2005: 11). Although presented at the time as both the common sense in Washington policy circles and with no alternative, it was still not the approach (at least in all its details) adopted in many advanced economies and was not the one adopted by the successful developing economies in East Asia.

Despite its poor track record in developing countries,[1] the idea of restoring growth by squeezing fiscal space – expansionary fiscal austerity – subsequently became the norm of macroeconomic policymaking across much of the global economy, especially after the GFC.

The turn to austerity was premised on a belief, hard-wired into conventional economic thinking, that business cycles are natural and that free and flexible markets can keep the economy at, or close to, its optimal growth path. Financial markets, it is assumed, allocate funds efficiently, correctly extend debt on a sustainable basis, providing governments with the appropriate incentives to undertake borrowing if required, and on the right terms, and that such a system would produce the most efficient outcome, i.e., allocate funds to those who can utilize it in the most productive way. Policy decisions, from this perspective, are best kept independent of democratic scrutiny and electoral cycles, ideally via an independent central bank singularly focused on low inflation, with credit rating agencies playing a key role in adjudicating the credibility of policy decisions. From this point of view, fiscal space is a residual outcome of getting market fundamentals right (Box 4.1).

Premature fiscal consolidation based on claims of the expansionary effects of austerity has continually impeded sustainable growth and development in the past ten years. After 2010, and despite widespread budget cuts, only a few countries succeeded in moving back to previous debt-to-GDP ratios. But growth rates stagnated virtually everywhere, while private debt, and attendant risks, expanded worldwide.

Together with the dismantling of permanent and anti-cyclical welfare structures, in the name of efficiency, conventional economic assumptions have undermined crisis prevention in the real economy, including public health emergencies. Governments then become unwilling or unable to actively reverse the destruction of productive capacity incurred during

recessions, or to mitigate distortions generated by financial markets obsessed with short-term movements in asset prices, even when those discourage long-term, productive investments. As with the GFC, the Covid-19 shock has underscored the need for a different approach to fiscal policy.

Markets, left alone, cannot efficiently provide society with the necessary collective goods and with the conditions for sustainable, equitable growth and development, regardless of the starting point. A mixture of active fiscal policies and more structural policies are then needed to fill the gap, policies that look beyond temporary stabilization and contribute to economic reconstruction. Adopting this longer-term perspective is, moreover, also the only sustainable route to stable public finances.

The time is ripe for a reorientation. As discussed in chapter I, the role of the State, including enhanced public spending, in saving lives and livelihoods has returned to the centre stage in response to the Covid-19 shock. The crucial role played by central banks in the latest juncture has, moreover, opened up the political space to question their independence and mandate beyond the emergency, and to reject the complacency of economic policy-making that bends to market sentiments and the judgement of credit rating agencies (Tooze, 2020). If governments seize this political space, they can develop strategies to escape the self-fulfilling trap of short-term (oftentimes speculative) expectations and increase their capacity for fiscal expansion that would create enough savings to achieve sustainability.

Those strategies include, domestically, a reorientation of the objectives of monetary policy and of tighter financial regulation towards equitable national growth and development strategies. Internationally, we could envision effective global agreements that help reduce asymmetries in accessing finance. In fact, if developed countries have reclaimed the right to policies that protect their domestic policy space from market forces, coherence and the collective interest of ensuring a balanced global recovery, dictate that developing countries, and particularly the most vulnerable amongst them, enjoy that freedom as well. Economic recovery is a precondition for fiscal stability, not the reverse.

This chapter analyses this issue starting with the dynamics of public debt. In section B, we discuss the dynamics of debt following the GFC, in both advanced economies and leading developing economies. Then, in section C, we examine the importance of fiscal expansion amid the Covid-19 shock. Section D outlines how economies might structure a progressive fiscal policy. Section E addresses balance of payments issues and fiscal policy. And section F concerns itself with how the international financial system affects room for fiscal manoeuvre.

BOX 4.1 Fiscal space: what, how and why

The IMF defines fiscal space as the "extent to which a government can allocate resources for a given purpose without prejudice of liquidity or long-term public debt sustainability" (IMF, 2012). In the conventional view, the main factors to take into account are the credibility of policymaking institutions, which determines the availability, maturity and cost of credit, and the debt-to-GDP ratio, which determines the repayment obligations and supposedly affects the rate of growth. The higher the level of indebtedness and the higher the cost of financing, the lower the fiscal space.

On this reading, if a country shows a commitment to run cyclically adjusted budget balances, it creates a fiscal buffer by taking advantage of the good times to save for bad times, increasing its ability to confront unexpected negative shocks, even if, exceptionally, that implies large deviations from the fiscal targets. In fact, financial markets will continue considering the country a safe creditor and provide the necessary liquidity without affecting the public bond yields. Similarly, if its central bank has engaged consistently in anti-inflationary monetary policy, it will be able, when necessary, to reduce real interest rates thus stimulating the recovery without generating fears of price instability. For this reason, even if a central bank is technically able to monetize public debt, the systematic use of this instrument is said to destroy its credibility and generate inflation. Ironically, central bankers in the developed countries have been willing to do "whatever it takes" in various contexts – which is to say, they have monetized public debt – but inflation has remained well below the target since the GFC.

Even within this conventional reading, views have evolved in some cases to recognize that fiscal expansions can have long-term positive effects on growth and that, under certain circumstances of prolonged underperformance, it is necessary to consider actions that go beyond the stabilization rule book (IMF, 2014: chapter 2; IMF, 2016: chapter 3; Furman, 2016; Fatas and Summers, 2018; Summers and Stansbury, 2019). While doing so often involves theoretical contortions to maintain compatibility with the standard theoretical

architecture (Storm, 2019; Seccareccia and Lavoie, 2019), these contributions largely mimic long-standing findings that monetary policy, if effective at curbing growth and inflation, is not an appropriate instrument to promote sustained growth. Instead, fiscal policy, especially public investments, are needed in order to support an economy otherwise tending toward under-employment equilibria (Kalecki, 1937; Keynes, 1936).

One further concern, however, has been raised: if large deficits, when temporary and exceptional, can be sustainable in a low interest rate setting (Blanchard, 2019), they still produce a risk, via an increase in the debt-to-income ratio. According to this view, increases in public debt absorb private savings, competing with (or crowding out) the private demand for funds. As a result, interest rates increase and reduce private investments. Private investments, it is argued, are also discouraged by the expectation that sooner or later the government will have to raise taxes to keep public finances sustainable. These explanations are based on strict and unrealistic assumptions about the capacity of economic agents to foresee the future and discount it, and they assume that investments cannot exceed the amount of savings initially available in the economy, thus ruling out private money creation.

However, the problem is ultimately conceptual. Even when a correlation between indebtedness and growth is found, nothing implies that the causation goes from higher debt to slower growth, rather than the reverse. The more sophisticated tests that try to control for this bi-directional causation (Kumar and Woo, 2010) still cannot exclude that the regularities may depend on the coincidental presence of pro-austerity economic and institutional contexts that are not pre-ordained. Nevertheless, it is the IMF and G20 recommendation that, after a public finance shock, governments should aim not only to stabilize the debt-to-GDP ratio, returning to a cyclically adjusted budget balance path after any deviation, but to reduce it, intensifying austerity.

Hence, the possibility of enjoying a speedy and sound recovery should be sacrificed to the pursuance of long-term fiscal space, identified as a low debt-to-GDP ratio and consistent access to financial markets. In the IMF words "the challenge for fiscal policy is to find the right balance between exploiting short-term space to support the fragile recovery and rebuilding longer term space by advancing fiscal consolidation." (IMF, 2012). Alas, no time is more appropriate to recall that, in the long run we are all dead.

B. Debt dynamics after the global financial crisis

The Covid-19 shock drew an active monetary and fiscal response to stop a global economic meltdown. As noted in chapter I, the global recession and the disaster-relief initiatives to fight the pandemic will raise public debt across the world. It is both normal and necessary for public debt to absorb most of the current economic shock, since the government is usually the only agent capable of borrowing heavily against future income to sustain current income in periods of severe crises.

To illustrate the countercyclical role of budget deficits and public debt, it is helpful to examine the change in the net public debt in some of the main economies of the world since the mid-2000s. By definition, the dynamics of the ratio of net public debt to GDP can be divided into four components (Escolano, 2010):

- the primary balance of the government (revenues minus spending excluding net interest payments);
- the net interest paid on government debt;
- economic growth (which reduces the debt ratio by raising its denominator); and
- wealth effects (the effect of changes in the market price of government assets and liabilities).

Together the four add up to the observed change in public-debt ratios. Assuming that wealth effects balance out through time, if the interest rate that applies to the stock of debt is higher than the rate of growth of GDP, the primary budget must be in surplus for the ratio of public debt to GDP to remain stable or decline. But if the rate of growth of GDP exceeds the rate of interest, the stability of this debt ratio is compatible with primary fiscal deficits.

The interest rate is determined in the financial markets, where private agents and the central bank buy and exchange government bonds. In countries that issue a reserve currency, central banks can readily influence the market price and keep bond yields in check, thus preserving fiscal space. But this is not the case for governments that hold debt denominated in foreign currencies and whose currency is

more volatile or that, as in the case of the eurozone countries or dollarized economies, do not have control over monetary policy. For them, the cost of debt depends on the expectations of private financial agents, which makes them vulnerable to self-fulfilling prophecies of debt unsustainability regardless of their efforts to increase the primary surplus.

In fact, these self-fulfilling expectations of fiscal difficulties can keep the real interest rate on government bonds high even in the face of persistent primary surpluses, rendering fiscal adjustments impotent. On the other hand, persistent primary deficits can be sustainable if market expectations keep the real interest rate paid by the government below the economy's GDP growth rate due, for example, to the "exorbitant privilege" of printing an international reserve currency (Eichengreen, 2011).

Wealth effects can also have a significant impact on the public-debt ratios of developing economies, where a large part of government debt is issued in foreign currency and/or the central bank maintains a high stock of international reserves and resorts to swap operations in foreign exchange to manage the economy's vulnerability to international shocks.

Moving to real-world cases and based on IMF data on the general government balance sheet,[2] the evidence since the GFC shows some interesting patterns. For example, data from the United States show an increase in primary deficits immediately after the GFC, followed by a gradual reduction, which nevertheless did not eliminate the deficit. Nevertheless, the relatively low interest payments by the Government of the United States and the growth of its economy were sufficient to stabilize the ratio of net public debt to GDP from 2013 onwards (figure 4.1A). In the case of Japan, the net interest paid by the Government has been even lower than in the United States since the GFC, which in its turn allowed the Japanese Government to avoid an explosion of its net-debt-to-GDP ratio despite its structurally high primary deficits (figure 4.1B). The common pattern in both economies has been low real interest rates, that is, an accommodative monetary policy that created fiscal space for non-explosive primary deficits by the fiscal authority, even in a slow-growth or stagnant scenario.

Europe has also registered low interest rates since the GFC, but with different implications for its main economies. In the case of the United Kingdom, the primary deficit spiked up in 2009-10 and then fell gradually until it reached zero in 2013. Despite the Brexit effect, net interest payments remained low in terms of GDP and the country's net public debt started to fall in 2016 (figure 4.1C). In contrast to the British Treasury, the Italian Government had a much lower primary deficit during the worst phase of the GFC, and a much faster fiscal consolidation after that, moving to a primary surplus as soon as 2011. Despite this more austere response, the Italian net public debt grew as fast as the British one in the past decade, in part, because of the relatively higher interest payments made by the Italian Government (figure 4.1D). Monetary sovereignty makes a huge difference for the carrying cost of public debt.

Germany had a relatively smaller primary deficit than its largest neighbours during the GFC and, as Italy, it also moved to primary surplus quickly after the shock, but with one important difference: net interest payments have been much lower in Germany than in Italy (figure 4.1E). The lower financial burden, together with a relatively faster growth recovery driven by exports, allowed Germany to reduce its net-debt-to-GDP ratio from 2011 onwards.[3] European fiscal diversity increases when we consider the case of France, where the GFC also raised the Government's primary deficit, but with no subsequent adjustment to surpluses as in Italy and Germany, or to a balanced budget as in the United Kingdom (figure 4.1F). Despite the deficits, the French Government's net interest payments have been smaller than in Italy, which nevertheless did not stop the country's net public debt from growing in almost all years since the GFC.

The fiscal situation continues to be diverse when we move to large developing economies for which IMF data on net public debt is available.[4] Starting with Mexico, the Government registered primary surpluses up to the GFC. The financial crisis then pushed the Government into deficits, for seven years in a row (figure 4.1G). The primary balance became positive again only in 2016, but despite the fiscal adjustment since then, the net interest payments by the Mexican Government have been higher in recent years than in the period of primary deficits. In the case of Brazil, the country registered uninterrupted primary surpluses from the early 2000s up to 2013, but with a relatively high net interest payment by the Government. The situation changed to primary deficits in 2014, with a temporary spike in interest payments in 2015-16,[5] followed by a reduction to its average level since then (figure 4.1H).

FIGURE 4.1 **Change in net public debt, selected countries, 2002–2019**
(Percentage of GDP)

Source: UNCTAD secretariat calculations based on IMF *World Economic Outlook* database.
Note: The primary deficit refers to net borrowing of the general government excluding net interest payments. The growth effect is the debt-to-GDP ratio of the previous period multiplied by minus the nominal GDP growth rate and divided by one plus the nominal GDP growth rate. The other effect is the difference between the observed change in the net-debt-to-GDP ratio and the cumulative effects of the primary deficit, net interest payments and growth.

Regarding other developing countries, the South African Government ran persistent primary surpluses before the GFC, but since then has had only primary deficits. The net interest payments remained high through both phases, which in combination with the primary deficit of recent years, have been pushing the country's net debt up since 2009 (figure 4.1I). In contrast, in the case of Turkey, the Government had a small primary surplus up until the GFC. The financial shock was accompanied by a small deficit in 2009, but since then the Turkish Government has had, on average, a practically balanced primary budget (figure 4.1J). Turkey's idiosyncrasy lies in government's net interest payments, which were high but decreasing before the GFC, and since then have remained relatively low when compared to other large emerging economies.

All of the above experiences follow the same accounting rules but suggest that there are many paths to fiscal stability or instability. In advanced countries that print their own money, it is usually possible to run primary deficits without explosive debt consequences due to accommodative monetary policy, including the acquisition of long-term government bonds by the central bank. The situation is less favourable in advanced economies that do not issue their own currency, such as in the case of countries in the Economic and Monetary Union of the European Union, and in developing countries that face a balance-of-payments constraint. The government net interest payments are usually larger in these two country groups, even where there has been an increase in the primary balance (as in Italy and Mexico). The exceptions seem to be countries where there is still a high degree of financial repression, as in Turkey, which tends to lower the financial cost of public debt.

C. Sustaining fiscal expansion amid shocks

Public-debt-to-GDP ratios will increase substantially in 2020 and, if the past is any guide, they will not return to pre-Covid-19 values quickly. In fact, a proper fiscal consolidation requires, first and foremost, economic recovery. Unfortunately, this principle did not guide responses after the GFC, when many economies tried to balance their budgets too soon, making their fiscal situation more fragile on the eve of the Covid-19 shock (*TDR 2016*; *TDR 2019*).

In some cases, premature fiscal consolidation was self-imposed, based on the false analogy between government and household budgets (Box 4.2) or the discredited hypothesis of "expansionary austerity" (Box 4.3). In other cases, especially in developing economies subject to strict balance-of-payments constraints, premature fiscal consolidation was adopted to obtain international liquidity and/or avoid a sharp increase in risk premiums. But no matter the cause, the strategy rarely worked as planned. The response to Covid-19 should therefore follow an alternative path, with more emphasis on economic growth and high employment rates as pre-conditions for achieving a stable ratio of public-debt-to-GDP. The approach can face political headwinds, since it usually means that, after a deep recession, the budget actions necessary for economic recovery will increase public debt further, that is, the public-debt-to-GDP ratio will increase before it stabilizes and starts to fall.

The temporary increase in public-debt ratios should not, however, be a reason for panic or doomsday scenarios, provided that the purchasing power created by the government is put to good use. In the long run, the additional public debt incurred to finance a faster and better recovery can be paid for by the increase in the potential output of the economy, especially if the starting point is a depressed level of economic activity and the fiscal expansion is targeted to raise investment and productivity (Box 4.4). And, even if the expansion proves to be insufficient to pay for the extra public debt issued to finance it, the gap can be met by an adjustment of taxation and/or public spending in the future.

There have been dramatic bursts of public debt in the past (Abbas et al., 2014), usually because of wars, followed by gradual fiscal consolidations, usually through a combination of economic growth, low real interest rate and non-explosive primary balances (Eichengreen et al., 2019) but also, not infrequently, debt cancellation (Hudson, 2018). The adjustment or fiscal rebalancing took more than a decade for advanced economies after World War II, and during the adjustment, the primary balance was either in surplus or deficit, depending on the economy's GDP growth and real interest rate. Evidence from the last 100 years suggests that deficits have been more common because there have been more periods during which GDP growth (g) outpaced the real interest rate paid by the government (r) than the reverse (Mauro and Zhou, 2020).

BOX 4.2 A dangerous analogy: the government as household

The debate on fiscal policy usually portrays the government as a household, stating that the former should balance its budget in the same way as a family (Wren-Lewis, 2018). Despite its appeal and popularity, the analogy between governments and households is misleading for at least four reasons:

i. The government is an infinitely living agent. Because of this the government may roll over its debt indefinitely. The constraint is not to pay the debt on some theoretical judgment day, but actually to roll over the debt in a non-explosive way every day (Domar, 1944).

ii. The government is a large enough agent, usually by collecting and spending a huge proportion of the economy's GDP, that its spending can influence its own revenue. Part of the government spending returns to the Treasury's coffers as revenue in the same and the future periods (Haavelmo, 1945; Shiller, 2010).

iii. The government can tax its creditors; households do not have the same power. The power to tax does not mean that the government can simply cancel its own debt by taxing the population, since economic history is full of tax revolts, from Babylon and the pharaohs all the way to modern-day governments (Burg, 2004). However, in the face of growing inequality, some form of progressive taxation offers a way to finance a progressive fiscal stimulus, in what used to be called a "tax-and-spend" strategy (Shiller, 2011).

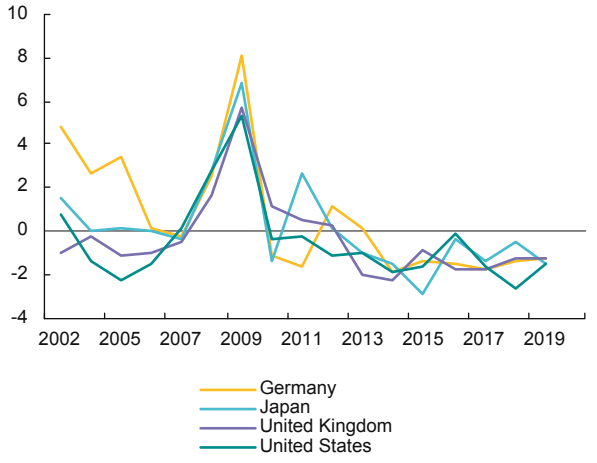
iv. The government can issue money. Every period, the growth of income raises the demand for money, allowing the government to finance part of its debt through zero-interest-rate bonds, also known as fiat currency (Kelton, 2020). As with taxation, the power to print does not mean an infinite power to spend, since when the money supply becomes excessive, high inflation reduces the demand for money (Buiter, 2007). Subject to this condition, the evolution of many economies since the GFC have shown that deficits can be financed at zero or negative real interest rates in a depressed economy (Rachel and Summers, 2019), with no inflationary effects.

Focusing only on the current century, most advanced economies were already in a situation of negative "r minus g" (i.e. GDP growth was higher than the real interest rate) on the eve of Covid-19 (figure 4.2). Specifically, the GFC pushed the average nominal interest rate on government bonds below inflation, meaning that the many governments could finance a fiscal expansion at negative real interest rates in a context of positive GDP growth before Covid-19.

The world is likely headed for a repeat of these circumstances. It faces a deep recession in 2020, and a recovery of global economic growth next year, albeit one subject to ample uncertainties: the further trajectory of the pandemic, policy responses to it, and the availability of a vaccine (chapter I). Still, we can expect that most advanced economies will, given their stance on monetary policy, be in a situation where "r" is smaller than "g". This situation should open minds to an important possibility: targeted fiscal expansion can pay for itself.

But for how long can such a fiscal expansion persist? To be sustainable, proposals for a fiscal expansion have to be credible, that is, they have to include the sequence and expected time frame of the fiscal plan, showing how the temporary increase in deficits will be financed, and how debt will be stabilized on a defined date in the medium-term future.[6] The Argentine Government applied this approach to its recent debt restructuring negotiations with official and private creditors, with considerable success (Government of Argentina, 2020).

FIGURE 4.2 Change in net public debt over previous years, selected countries, 2002–2019
(Percentage of GDP)



Source: UNCTAD secretariat calculations based on IMF *World Economic Outlook* database.
Note: "r minus g" is the difference between the growth rate of real GDP and the real interest rate implicit on the net government debt of the general government, with the latter calculated from the GDP's deflator and the observed values of interest payments and net debt.

BOX 4.3 A dangerous idea: the case against expansionary austerity

The hypothesis of "expansionary austerity" suggests that a period of contractionary fiscal adjustment often coincides with one of economic expansion. The results, however, even in the work of its most ardent proponents, are not convincing.

Specifically, in a seminal paper by Alesina and Ardagna (1998) using a sample of 51 fiscal adjustments, austerity failed to meet the authors' criteria of fiscal success (a reduction in the cyclically adjusted primary deficit to GDP and debt-GDP ratio by a certain percentage in the following three years) in 32 cases (63 per cent of the total). If we consider the authors definition of "expansionary" (the difference between a country's growth rate and the G7 average rate during periods of fiscal adjustment is in the top quartile of the distribution), austerity was actually contractionary in 28 cases (56 per cent of the total). In a later work by Alesina and Ardagna (2009), examining 107 cases of fiscal adjustment, the contractionary measures failed to improve public finance in 86 cases (80 per cent of the sample) and austerity was contractionary in 81 cases (76 per cent of the sample).

Focusing on the 26 cases of expansionary austerity, a closer inspection showed that the success as defined by the theory's proponents only occurred when a fiscal contraction happened *during* a boom or, in very few cases, when either interest rates or the exchange rates were falling sharply (Jayadev and Konczal, 2010). In fact, the most prominent cases of expansionary austerity studied until that time happened in small open economies, after substantial changes in the real exchange rate, based on an expansion of net exports (Perotti, 2011). Moreover, the two authors, by wrongfully identifying a fall in public spending to GDP with discretionary cuts, run into a reverse causality problem, that is they obtain – by construction – that the fall in spending causes GDP growth, rather than the reverse (Guajardo et al., 2011; Breuer, 2019). Despite the lack of supportive evidence, "expansionary austerity" became the policy mantra in many countries because it allowed elected authorities to promise adjustment without pain, apparently avoiding the "Juncker's curse", the low probability of re-election after adopting a restrictive fiscal policy and unpopular institutional reforms (Buti et al., 2018).

Expansionary austerity became even more popular among policy circles after the GFC, when many authorities around the world feared the effect of the build-up in public debt due to countercyclical policies to attenuate the recession, namely they feared destabilizing speculative attacks against the sovereign debt in financial markets, the irony of which should not escape the reader. As a result, in 2010, the leaders of the G20 changed gears and recommended that, from then on, their Governments should adopt "growth-friendly fiscal consolidation". There was indeed austerity and, in some cases, consolidation, but it was not friendly to growth (*TDR 2016*).

If it were a medical treatment, expansionary austerity would certainly have come with a health warning but would not have made it through the requisite clinical trials. Most of the economists' community was not so careful and the result was that austerity was preached, adopted and failed, leaving considerable economic damage and an angry group of patients (voters) in its wake.

The debate on whether austerity was expansionary or contractionary distracted from another important issue for economic policy. What are the conditions under which fiscal contraction may be necessary to avoid an explosive public-debt-to-GDP ratio and its adoption in the most timely and fairest manner? While for many developing countries austerity has not been a choice, but a requirement for accessing multilateral finance in order to meet external obligations, economic history and common sense recommend that "the boom, not the slump is the right time for austerity at the Treasury" (Keynes, 1937). As for the how, expansionary austerians have advocated spending cuts on the grounds that these are less recessive than tax hikes (Alesina et al., 2017). However, others have shown that the effect of spending cuts and tax hikes vary according to the volatility of the economy under analysis (Wiese at al., 2018), as well as its initial condition (Saez and Zucman, 2019). But ultimately, aside from econometric issues, government taxation and spending inevitably involve a political judgment about the priorities of the society rather bending to an unsupported textbook logic.

None of these insights are new, but they have been too often forgotten; now is the ideal time to recover them. What is new is the need or urgency to face the fiscal challenge posed by Covid-19 in a more progressive way than after the GFC, the need to recognize that economic recovery is a precondition for fiscal consolidation, not the reverse. The literature shows that there is more than one path to debt sustainability (Ciccone, 2013; Eyraud et al., 2018) and, more importantly, when it comes to their own economies, advanced countries are usually more tolerant of a gradual consolidation than when they discuss the case of developing countries (Lledó et al., 2017).

But what is a "targeted fiscal expansion"? The combination of negative real interest rates and positive GDP growth allows the government to run primary deficits and stabilize its net-public-debt-to-GDP ratio at the same time. However, that fiscal space must be put to good use, in order to persist; careless fiscal expansion can jeopardize sustainable growth and price stability. Moreover, just like fiscal contractions, expansionary policies have social and political consequences that need to be analysed and openly discussed, be they disaster-relief or reconstruction initiatives. The magnitude and composition of the fiscal impulse to the economy should therefore be planned to have the maximum positive impact on income growth, employment and welfare, recognizing that this may differ substantially depending on the country-specific circumstances.

D. Progressive fiscal policy in advanced and developing economies

The pandemic highlighted the importance of public health policies for the well-being of the population and the functioning of the economy. Countries with strong and universal public health systems tended to deal better with the surge in demand for medical tests and treatments caused by the pandemic than countries with solely market-based or out-of-pocket health systems (Scott, 2020; OECD, 2020). The necessity for better public health systems is more urgent in developing countries and the few advanced nations that do not have an adequate public health system.

A national or mission-oriented programme to improve public health, including better water and sanitation for low-income households, is an obvious and urgent candidate for progressive fiscal policy in many countries, one that would create jobs, raise productivity and boost innovation. (Craven et al., 2020), for example, has estimated that the world will need to spend $70 billion to $120 billion over the next two years, and $20 billion to $40 billion annually thereafter, to substantially reduce the likelihood of future pandemics, with international financial support to developing countries of particular importance (see chapter V).

As noted in chapter I, the Covid-19 shock also showed that a large part of the population is vulnerable to sudden stops in economic activity, both in advanced and developing countries. In the former, because of the reduction in formal employment and the increase in the gig economy in recent years, many citizens no longer have proper access to social safety nets when income insurance is needed. In middle- and low-income economies, informal precarious employment has been a constant throughout their history, with a large part of the labour force being "invisible" to government programmes.

The policy response to Covid-19, in both developed and developing countries, has tried to address this problem through emergency income transfers – a sort of temporary basic income – with clearly positive effects on welfare. In fact, preliminary evidence from some developed and developing countries indicates that emergency cash transfers actually raised savings and reduced poverty compared with the period before the pandemic (Duque, 2020; Gagnon, 2020). This result should give policymakers (and economists) pause to think whether the world should really go back to the pre-pandemic normal.

The success of temporary emergency cash transfers to attenuate the income loss for millions of people in a moment of crisis has reinforced proposals for

BOX 4.4 A self-sustaining fiscal expansion

In response to the Great Depression of the 1930, fiscal policy was more effective than monetary policy to pull an economy out of a recession (Keynes, 1936). This view persisted through the 1960s, when fiscal policy became an important tool for economic stabilization (automatic stabilizers) and development (public investment and social safety nets) in both advanced and developing economies.

Fiscal policy lost importance during the Great Inflation of the 1970s (Sargent, 2018), when monetary policy became the main instrument for economic stabilization and fiscal policy became stigmatized in the eyes of many economists (Sargent and Wallace, 1981) and most governments decided to rely more on market forces than on government action for economic development (Harvey, 2007). Independently of the long-run result of such a choice, fiscal policy regained importance in recent years because of the failure or exhaustion of monetary policy to bring economies back to their pre-2008 growth trends. Quantitative easing and low real

interest rates did avert a global financial meltdown, but they have not been sufficient to accelerate growth and development in many economies in the last twelve years (Blanchard, 2019).

The renewed interest in fiscal policy led mainstream economics to resuscitate an idea that had been emphasized by Keynesian (from Lerner to Tobin and from Kalecki to Kaldor) or post-Keynesian economists (Minsky) for a long time: in a depressed economy, fiscal policy can actually be self-financing (Cerra and Saxena, 2008; De Long and Summers, 2012). More formally, significant changes in aggregate demand tend to have a permanent effect on potential output, meaning that short-run spending decisions can alter the volume of capital-per-worker and labour productivity in the long run (Ball, 2009, 2014; Haltmaier, 2012). Borrowing a term from physics, economists call this phenomenon "hysteresis" (Blanchard and Summers, 1986), meaning that a national economy does not necessarily return to its original shape after a substantial shock.

If even a short-run demand shock can alter the long-run potential output of the economy, an expansionary fiscal policy does not have to be inflationary. It can expand the productive capacity along with demand and create the necessary savings, via higher tax revenues and lower anti-cyclical expenditures, to pay or roll over the debt issued in the short run. In other words, a fiscal expansion can be self-financing and allow the government to balance the budget. The other benefit, of course, is that, if the GDP increases relative to the interest rate, the debt ratio falls or at least stabilizes.

As with expansionary austerity, the idea of self-financing fiscal expansions should be subject to empirical support. Girardi et al., (2020), for example, do find that increases in autonomous demand have a highly significant and strikingly persistent level effect on GDP while Gechert et al. (2017) find strong and persistent long-run multiplier effects for most European countries in the early years after the GFC and the subsequent eurozone crisis. Even when a fiscal expansion pays only partly for itself, it is still necessary to ask whether in its absence the debt stabilization would be achieved any more quickly. For example, Gechert et al. (2017), find that the turn to belt-tightening in the European Union was badly timed and therefore much more costly in terms of long-term output loss than a more gradual, backloaded consolidation.

In contrast to what happened with expansionary austerity, the conditions under which a self-financing fiscal expansion can occur have not received much emphasis in the economic and policy literature. To remedy this, it is useful to state these conditions in intuitive terms.

First, when the average real interest rate paid by the government is below the growth rate of real GDP, a fiscal expansion is likely to self-sustaining for the sheer fact that the government can borrow now and pay less than what it initially borrowed later in real terms. In other terms, when "r" is below "g", fiscal policy becomes the main candidate to stabilize and expand the economy.

Second, when the economy is in a deep recession, it is much easier for fiscal policy to have a positive effect on potential output. The cost of not expanding public net spending is also higher. A high rate of long-term unemployment gradually reduces the human capital stock of the economy, and a long period of sluggish growth tends to postpone or cancel investment and innovation decisions, with a permanent impact on potential output.

Third, the higher the impact of fiscal policy on potential output – the long-run fiscal multiplier – the higher the probability that a fiscal expansion will be self-financing. Since the GFC, the empirical literature on the size of fiscal multipliers has shown that fiscal policy has a higher impact on income and employment than experts initially expected (Blanchard and Leigh, 2013).

Putting all three conditions together and considering the impact of Covid-19 on the world economy, the probability of a self-financing fiscal expansion seems to be higher now than in the past. But, even if the fiscal expansion does not prove to be self-financing, the low real interest rates expected for the next years in many economies indicate that the present value of the additional primary surplus necessary to stabilize public debt in the future is much lower than the additional debt issued to finance an expansionary policy today. In other words, a fiscal expansion may not fully pay for itself, but with "r" below or close to "g", it surely pays for a huge part of itself.

a more permanent programme of universal basic income that pre-date the Covid-19 crisis. In fact, such proposals have been around for centuries, dating back to at least Thomas More's "Utopia" in the early 16th century (*TDR 2017*). What is new is that the modern world has the resources and technology to sustain a permanently higher income level for most of its population without compromising productivity and financial stability (Lindert, 2003, 2009; Standing 2020). However, income redistribution is, as ever, a political issue, influenced by the resources and technology of the era.

In today's world, the pandemic showed the need for a more encompassing system of income insurance, covering not only the risk of unemployment for formal workers, but also the risk of income losses for informal and self-employed workers. Whether or not this will evolve into a full-fledged system of universal basic income is a topic for ongoing debate and discussion. But this debate should not stop governments around the world from improving their social security systems. With today's information technology, it is simply unacceptable for some countries to have a large part of their low-income population invisible to insurance and aid programmes in a crisis. Investing in a better social security is therefore another candidate for fiscal action after Covid-19, especially in developing economies.

Government transfers can be done in cash or in kind. The latter includes universal public services and is at least as important as the former. To take the obvious example of the moment, the pandemic has demonstrated the value of a good public health system for society and the economy. The same holds for public education and access to some basic services necessary for full citizenship in the 21st century. The digitalization of the economy was a growing policy priority of many governments before the pandemic and, arguably, has become more so since. The development of information and artificial-intelligence technologies have already delivered substantial productivity gains. In this context, the Covid-19 crisis has exacerbated the existing inequalities in access to electronic information, both in work and education networks. The fiscal response to the pandemic should therefore include more public investment in digital or information inclusion, especially in developing economies, including in targeted skills training but also in basic public education.

The same logic holds for access to credit, but this problem was evident before Covid-19. The effects of the GFC showed that the private financial system does not work properly after systemic shocks, that central banks have to inject massive amounts of liquidity into the system to avoid a financial meltdown, but that this action alone does not assure that credit will reach those who need it most. Now, many individuals and small enterprises desperately seeking credit to stay afloat, even while the economy begins to recover, but cannot given the biases in the existing private credit system (*TDR 2019*).

The response of most governments has been faster during the Covid-19 crisis than in 2008–09, with the prompt creation of many credit lines or facilities to assist families, firms and regional administrations. However, as in 2008-09, these initiatives have fallen short of expectations, indicating that there remain not only fundamental information and incentive problems, for example, with respect to loans to small businesses (Wigglesworth, 2020), but also deeper political resistance to changing a financial system riddled with biases and inequities. And particularly for developing countries, asymmetric power relations in private credit provision during periods of stress have complicated relief efforts. Private agents will simply not supply the credit needed because of the systemic risk involved. In this context, only the government – and sometimes not every government – can reduce such risk, through proper guarantees for both liquidity risk (repos for the people) and credit risk.

The form and size of credit actions varies across countries. In economies where the Government still has public banks – such as Germany's Kreditanstalt für Wiederaufbau (KfW) – most of the liquidity and credit assistance can be provided through government action outside the balance sheet of the general government. Where this is not the case, liquidity assistance can be provided by the central bank without much difficulty, but the reduction of credit risk requires appropriate public economic and financial authorities to inject capital in to special-purpose funds designed to bear the first or large part of losses due to higher delinquency rates during the crisis and the reconstruction. This kind of action will be needed in both advanced and developing economies, but in different degrees depending on the institutional organization of their financial systems.

The fourth area for fiscal action is public investment and employment, both for economic and social reasons (chapter III). *TDR 2019* analysed how to finance a Global Green New Deal, that is, an investment strategy to create jobs, promote social inclusion and fight climate change, with a leading role for the public sector. The issue remains as urgent as before the pandemic and the adoption of the proposal for a Global Green New Deal can now accelerate economic recovery over the next years.

Halting rising global temperatures, mitigating environmental destruction and advancing social inclusion requires economic transformation, which in turn requires the "creative destruction" of existing carbon-based capital and technologies and shifting to renewable energy, raising energy efficiency, employing more labour and distributing the gains of

productivity growth in a more equal way. The novelty is that because of the Covid-19 recession, a large government-led investment initiative can accelerate the economic recovery from the pandemic, creating jobs in addition to redistributing income.

The main opportunities for direct or government-induced investment are:

- *The environment*: preservation of forests, river and oceans, including the recovery of degraded biosystems, with massive reforestation, and heavy investments in recycling and waste management systems.

- *Urban development*: city renewal and transformation, especially in better and greener urban transportation, as well as better housing, water and sanitation conditions in developing countries.

- *Energy*: decarbonization of power generation and increase in energy efficiency, through better regulation and more investments, as well as wider use of information technologies in smart grids of power distribution and machine-to-machine communication.

- *Universal public services*: expansion and improvement in public health and education, also with greener technologies and better use of information technology, and smart investment in public security to reduce crime rates and improve the judicial and penitentiary system, especially in developing countries.

Public investment should aim to crowd in new private investment. Even where critical projects – especially in infrastructure – are dominated by private investment, some degree of government coordination will be required. The challenge of promoting structural changes to production and consumption patterns necessary to preserve the environment, while raising the living standards of millions of people, involves many natural monopolies, large indivisible investment projects and new technologies. Market forces can help to accelerate this transformation, but history shows that this usually requires either government incentives or direct government action. Fiscal policy as an instrument for development rather than macroeconomic stabilization only will need complementary industrial policies (chapter II).

The political challenges to economic reconstruction can be pronounced in advanced economies, given the (often) high sunk costs in the current patterns of production and consumption and powerful vested interests that benefit from them. Where the capital stock is higher, creative destruction will be larger, but this can be attenuated by the fact that advanced economies also have higher income levels and, at least theoretically, better institutional systems to deal with the inevitable social conflict associated with structural changes.

In the case of developing economies, the sunk cost in existing modes of production and consumption is smaller and, therefore, the economy can theoretically leapfrog to new technologies. In practice, things are not this simple because there can be many other bottlenecks to impede economic transformation. This includes material impediments (such as the lack of adequate human capital or limited supply of food and energy), as well as often severe financial bottlenecks (such as the lack of foreign currency to finance growing import demand for intermediary inputs). In fact, for most developing economies, a fiscal expansion is usually blocked from a financial rather than a real constraint, with the balance of payments still binding. In addition, in developing countries with fragile political institutions and settlements, there also is a high risk of political destabilization when vested interests in pre-existing production structures resist change.

E. Fiscal policy and the balance-of-payments constraint

Countries that issue international reserve currencies have more fiscal space than the rest of the world because they are in a position to finance their government budget deficits in domestic currency. The fiscal constraint can still materialize through adverse risk premium and exchange-rate volatility. Yet, it is usually less stringent than in countries that issue government debt in an external unit of account because they have to maintain a minimal level of international reserves in foreign currency to deal with external shocks.

Even where developing countries possess the essential components of a financial infrastructure,

including central banks, commercial banks and development banks, the scale of financing required to achieve structural transformation and sustainable development within a meaningful time frame means that developing countries will still have to rely on external financing, including external debt. In the context of late development, debt is often associated with external sovereign debt owed by developing country governments to foreign, private and official creditors, usually in foreign-denominated currency. But in addition, hyperglobalization and the concomitant deregulation of cross-border financial transactions has increasingly facilitated private indebtedness in foreign-denominated currency, even in the poorest of developing countries (Box 4.1).

In theory, developing economies with floating exchange rates and a domestic bond market can finance a fiscal expansion internally. In practice, in small open economies, but also in larger economies, such an expansion can quickly worsen the country's current account balance if the world economy is stagnant, resulting in a shortage of foreign exchange if there is no compensating inflow of foreign capital to finance the domestic expansion. In other words, developing economies usually face a more stringent balance-of-payments constraint than advanced economies (Thirlwall, 1979; Thirlwall and Hussain, 1982).

The nature of the constraint varies in the developing world (Moreno-Brid, 1998; Barbosa-Filho, 2001). In large economies with floating exchange rates and a sizeable stock of foreign reserves, a substantive fiscal expansion usually leads to currency depreciations and higher risk premiums. In smaller economies with fixed exchange rates, less prevalent today than 30 years ago, the balance-of-payments constraint quickly turns into a monetary and fiscal constraint, through a reduction in credit, tax hikes and spending cuts. The similarity with the experience of some advanced economies in trying to defend the gold standard in the 1930s is not a coincidence.[7] Maintaining a fixed exchange rate in a stagnant world economy can quickly develop into a political crisis because of the social impact of the contractionary policies required do defend the peg.

Similarly, a small open economy that does not issue an international reserve currency must produce a positive primary balance (its current account excluding net interest payments) to roll over its net foreign debt smoothly. However, to make matters more complicated, when analysing the balance-of-payments constraint, the possibility of purely speculative changes in asset prices, for example through synthetic operations in derivatives markets, without huge inflows or outflows of capital must also be taken into account.

In other words, due to the financialization of the world economy after the breakdown of the Bretton-Woods system (Epstein, 2005), currency crises and the balance-of-payments constraint can also operate through exchange-rate volatility originating in arbitrage operations in foreign markets. If part of domestic debt is indexed to the exchange rate, these speculative fluctuations can create severe problems, such as abrupt falls in spending and production due to balance-sheet effects, without large variations in the economy's financial flows with the rest of the world.

Sudden and substantial exchange-rate "realignments" and the capital losses associated with them can therefore turn a fiscal constraint into a financial crisis, blocking economic recovery. In the case of developing economies, the link between the fiscal and the balance-of-payments constraint depends crucially on two issues: the financial markets' opinion about the country's economic policy and the government's ability to withstand an adverse reaction of financial markets if and when it tries to move against conventional wisdom.

On the first issue, unfortunately, many people continue to analyse international finance as they would household budgets, promoting a contractionary adjustment to avoid an increase in public debt and deficits, as if the entire world could run a surplus against itself. As accountants know full well, for someone to have a surplus, someone else must have a deficit (Godley and Lavoie, 2012). In terms of international finance, this means that if every country tries to improve its current account at the same time, the result is a race to the bottom and a global depression as demand withers away.

On the second issue, in theory, some large developing economies can swim against the tide of markets if they have an initial low public-debt-to-GDP ratio and a relatively high stock of international reserves (Barbosa-Filho, 2005). If there is fiscal room to expand public debt after a contractionary shock, and sufficient foreign currency in the electronic coffers of the central bank to deal with exchange-rate volatility, the government can adopt countercyclical policies during a recession and transformative policies after it. Limited capital mobility also reduces

the link between the fiscal and balance-of-payments constraints, and while it is difficult for many developing countries to pursue capital account management unilaterally, a supportive international regime can make this a viable option.

In practice, public-debt-to-GDP ratios, and other indicators of overall debt vulnerabilities, were already high in many developing economies before the pandemic and, even for countries with a large precautionary stock of foreign currency, adverse changes in exchange rates and rising risk premiums can block the adequate level of fiscal stimulus domestically.

Hence, inevitably, a progressive solution to the problem requires a much more active leadership role from advanced economies and multilateral institutions to advance more effective regulation of volatile capital flows and push market opinion in the right direction and, most importantly, in supporting a coordinated expansionary response to a contractionary shock. Developing country success in response to the Covid-19 shock will be impossible without thoughtful policy in the advanced economies.

Countries that issue an international currency can do more for themselves and the rest of the world. The initiative can come through either notional support to developing economies in swap agreements, as done by the Federal Reserve of the United States following the GFC, or emergency credit lines and debt standstills in face of exogenous adverse shocks. As discussed further below, the automatic provision of international liquidity in the form of special drawing rights (SDRs), and political support for multilateral financial assistance to the developing world, especially to low-income countries that lack a developed domestic bond market and have limited access to foreign finance, will be critical.

In the same way that quantitative easing created more space for expansionary fiscal policy in developed economies, internationally coordinated financial easing of balance-of-payments constraints in developing nations can create more space for economic reconstruction in these countries. Obviously, external finance does not guarantee successful economic reconstruction in developing nations, for example when funds or relief fail to raise productivity and income in a sustainable way. For public and private external finance flows alike, national development strategies must channel these funds into productive, long-term development projects.

F. The international financial system and fiscal space after the pandemic

Fiscal space, broadly defined as sustainable financing available for the public sector's budget, is mostly associated with institutional and policy support at the national level but it is also determined, in no small measure, by multilateral rules and practices. Some of these are collective actions whereby governments voluntarily reduce their fiscal sovereignty in certain areas on a reciprocal basis in the expectation that this will generate net benefits for all. Multilateral disciplines on tariffs imposed by the WTO in the area of international trade is one such example. There are also multilateral rules and practices which are not based on voluntary commitments but stem from asymmetric power relations. Fiscal space in developing countries is greatly affected by these rules and practices.

Multilateral rules and practices have evolved over the last four decades in the direction of weakening the ability of States to preserve or expand their fiscal space. Crucial constraints have been imposed by way of international arrangements and agreements, by policy conditionalities on international lending, by a threat of international tax competition between countries and by an intensifying hyperglobalization that has precipitated increased mobility of capital, illicit financial flows (IFFs) and a greater use of tax havens (*TDR 2014*). Unchecked market concentration and the spread of global value chains have often reinforced these trends (*TDR 2018*).

To recover faster and better from the Covid-19 crisis and build a more resilient economy based on inclusive and sustainable growth, both developed and developing economies will need as much fiscal space as possible. However, as noted in chapter I, the crisis has revealed not only the importance of fiscal space, but the constraints on its expansion in developing countries. This asymmetry can, in part, be addressed through existing multilateral arrangements. But there is also a need for more radical reforms of the global economic governance architecture to alleviate this constraint (chapter V).

1. Expanding fiscal space through existing arrangements

As developing countries struggle with both public health and the economic fallout from the Covid-19 crisis, creating fiscal space is a high priority. Public health resources needed to control the pandemic and flatten infection rates are of such magnitude that other uses of fiscal revenue will, without appropriate support, be squeezed, given the limited fiscal space in developing countries. At the same time, as discussed in previous chapters, government spending is key to boosting demand in support of recovery.

To help create conditions for an adequate response, the international community can adopt various measures which will help expand fiscal space of developing countries in the short term. First on the list is relaxing financing constraints through an expansion of SDRs (UNCTAD, 2020a). Second, a global debt deal with temporary standstills and debt reliefs (chapter V; UNCTAD, 2020b) would reduce outlays related to debt obligations, freeing up existing fiscal resources for public health response to the pandemic. Third, an immediate moratorium on all investor-state dispute settlement (ISDS) claims against governments under international investment treaties (bilateral or plurilateral) would temporarily protect developing country revenue (chapter V).

The proposal to use SDRs to ease the fiscal burden on developing countries has already received a good deal of attention since the start of the Covid-19 crisis, in fora such as the G20. The extent to which the provision of SDRs to developing countries, in the current crisis, will alleviate significant pressures on domestic fiscal space in developing countries, depends on their size and on the channels through which any combination of re-allocated and new SDRs is effectuated (Box 4.5). In the case of either reallocating or, alternatively donating unused SDRs in high-income countries (possibly by re-depositing these with the IMF), additional fiscal space could be provided more rapidly but would remain rather limited in size. While there are currently SDR 204 billion (about $288 billion) in circulation, early estimates by IMF and UNCTAD put liquidity shortages in the developing world at around $2.5 trillion at the onset of the Covid-19 crisis.

A new allocation of SDRs is needed to bolster crisis-hidden developing countries' international reserve positions and increase their fiscal space indirectly through the mentioned macroeconomic channels.

TABLE 4.1 Shares of a $1 trillion SDR allocation to developing countries and transition economies, selected country groups, 2020

Country groups	*Quota*	*Receipt of a global $1 trillion equivalent of SDR injection for developing countries and transition economies*	
	(Percentage of total SDRs)	*(Billions of dollars)*	*(Percentage of GDP)*
High-income developing countries	24.0	611	2.5
Middle-income developing countries	9.5	242	3.4
Low-income developing countries	1.5	39	7.3
Transition economies	4.2	108	4.6
All developing and transition economies	**39.2**	**1,000**	**2.9**

Source: UNCTAD secretariat calculations based on IMF Balance of Payments database.

Proposed amounts range from the equivalent of $500 billion[8] to new allocations of the equivalent of $1 trillion to $3 trillion (Gallagher et al., 2020; UNCTAD, 2020a; CEPR, 2020). Higher figures take account of estimates for liquidity needs in developing countries and of the current IMF quota system. This will allocate around 39 per cent of newly created SDRs to all developing countries. Thus, for $1 trillion in SDRs to reach developing countries, an overall SDR allocation worth around $2.5 trillion would be required. Table 4.1 further details how, in this example, an allocation of $1 trillion in SDRs to developing countries would be distributed across developing country income sub-groups.

Further redistribution of unused SDRs in advanced countries, through donations, transfers to IMF funds, and based on a new overall SDR allocation, would then help to support fiscal space to respond to the Covid-19 crisis in developing countries.

A more direct way to enlarge fiscal space in developing countries would be through debt suspension and relief. The most prominent proposal at present is the G20-Paris Club "Debt Service Suspension Initiative (DSSI)" for poorest countries (G20, 2020). Under this initiative, 73 primarily low-income developing countries are eligible for a suspension of debt repayments to their bilateral creditors between May

BOX 4.5 Special drawing rights and fiscal space

The special drawing right (SDR) is an interest-bearing international reserve asset, which the IMF can create to meet the long-term global need to supplement its member countries' existing official reserves.[11] Its value is based on a basket of currencies, comprising the dollar, Japanese yen, euro, pound sterling and Chinese renminbi, set daily by the IMF, based on market exchange rates. SDRs represent a potential claim on freely usable currencies of IMF members and can be held by member countries, the IMF, and certain designated official entities, but not by private entities or individuals. General SDR-allocations require approvement of at least 85 per cent of the total votes held by IMF members, of which 16.5 per cent are held by the United States. The three general allocations (in 1970–1972, 1979–1981, 2009) and the only special allocation (in 2009) amount to a cumulative total of SDR 204 billion, or $277 billion, as of May 2020.[12] Of these SDR 183 billion or almost 90 per cent of the cumulative total, were allocated (through combined general and special allocations) in 2009 in response to GFC. SDRs are allocated unconditionally without regard to a country's macroeconomic policies. They are not reimbursable and do not have a maturity date or a scheduled amortization table but carry a symbolic interest rate of 0.05 per cent (where current holdings differ from statutory allocations).

Countries can (i) hold SDRs as international reserves; (ii) exchange them for freely usable currencies by selling SDRs to other IMF members, including an IMF designated purchaser;[13] (iii) lend or donate unused SDR allocations under the quota system to countries in need of additional SDRs; or (iv) use these in operations with the IMF, to fund concessional IMF lending facilities, such as, at present, the Poverty Reduction and Growth Trust (PRGT) and the Catastrophe Containment and Relief Trust (CCRT). SDRs cannot be used directly for operations in financial markets.

In May 2020, low- and lower-middle-income countries held only 5.5 per cent of the SDR 204 billion currently in circulation. This figure rises to 24 per cent, if upper-middle-income countries are included. Newly-issued SDRs are allocated to countries in accordance with each country's quota share at the IMF and low- and lower-middle-income developing countries are the primary users of SDRs. Thus, by May 2020, low-income and lower-middle-income countries had used 58 per cent and 52 per cent of their current allocation of SDRs, respectively, compared to 18 per cent for upper-middle-income countries and 4 per cent for high-income countries.[14] Regarding the 2009 allocation alone, most of the 21 countries that sold a significant part of their allocation within one year were developing countries (IMF, 2018).

Since SDRs are an international reserve asset limited to payments between central banks and between these and the IMF, therefore not an international currency circulating more widely, their primary function is to alleviate balance-of-payment constraints by providing developing countries with additional reserve assets to hedge their foreign-exchange denominated liabilities. This can contribute to freeing up domestic fiscal space in developing countries indirectly in a number of ways.

First, the provision of SDRs to developing countries' international reserve accounts – be this through donation or re-allocation of existing SDRs from developed to developing countries or through the creation of new SDR allocations by the IMF under the current quota system (or a combination of both) – is essential to allow developing countries to avoid or minimize a deterioration of their trade balances in the wake of an exogenous crisis, such as the Covid-19 crisis. If essential imports can be maintained or even expanded to meet crisis demands, for example in the health sector, this contributes to government finances through continued or even rising customs duties. It also helps to keep likely inflationary impacts of otherwise necessary contractions of essential imports at bay, that would adversely affect tax revenue. Similarly, and on the export side, using newly-received SDRs in trade finance guarantee programmes could help to avoid a fall in exports of goods and services that provide income to people and tax revenues to governments.

Second, and relatedly, the provision of SDRs and the increase in foreign exchange reserves, can facilitate stable exchange rate management and, in particular, allow for intervention in foreign-exchange markets to contain or avoid the risk of crippling domestic currency depreciations. Substantive currency depreciations also affect a country's trade balance by raising the domestic currency price of imports (thereby reinforcing any inflationary impacts from a volume contraction of imports), while gains from a fall in the foreign currency price of exports are unlikely to translate into higher export volumes in a global economic environment marked by shrinking global aggregate demand. Equally importantly, a country's ability to maintain a stable exchange rate limits increases in the value of foreign currency-denominated debt, including sovereign external debt, that would directly undermine its fiscal space.

Third, SDRs, once exchanged for hard currencies, can be used to facilitate the conversion (or swap) of a government's foreign debt obligations into domestic debt obligations and/or to auction hard currencies to

domestic investors, including state-owned enterprises. Both operations can enhance domestic fiscal space by increasing tax revenue from private and public sector investment activity and by allowing for a government's more flexible management of its domestic debt burdens, including through interest rate policies.

Fourth, in the event that the provision of SDRs, combined with strengthened international reserves and stable exchange rate management also bolster the confidence of financial markets and/or positively influence credit ratings, this could lower (or prevent an increase of) a country's external debt-servicing costs, thus enhancing its fiscal space to mount domestic stimulus packages. In addition, sustained confidence of international financial investors in the economy, could help to stem a retreat by non-resident holders of domestic currency-denominated debt from such securities. Where non-resident positions are important enough relative to the size of overall market for domestic securities, this would furthermore preserve fiscal space by avoiding concomitant currency depreciations and concomitant domestic interest rate hikes.

Fifth, high-income countries with large amounts of unused SDRs can also choose to transfer these to the IMF to provide concessional financing or join international debt relief efforts through dedicated funds. As mentioned, this has so far included the PRGT and CCRT Funds. In addition to further SDR injections to these funds to sustain related lending (and debt-creating) activity by the IMF in the current crisis, or else alternatively to this, high-income countries could pledge their unused SDRs to provide the capital for a Covid-19 response investment fund (Plant, 2020). Such a fund could issue bonds based on its SDR-capital and undertake investments in projects related to the Covid-19 crisis, focuses on both health issues as well as wider economic recovery measures. The SDRs would remain part of the pledging countries' reserves to the extent that the fund was commercially viable and SDRs serve as a guarantee only, while the investments undertaken by the fund in developing countries would free these countries' fiscal space for other purposes.

and December 2020, potentially freeing up an estimated total of $12 billion. By end-July 2020, 41 of the eligible countries had signed up to the initiative, with around $7 billion in debt repayments due to official bilateral creditors for the duration of the initiative.

Participation comes with a number of conditionalities, including an active borrowing status with the IMF (or a request for future IMF financing), proven use of temporarily freed-up resources for increased health and economic spending in response to the Covid-19 crisis and full disclosure of their public debt obligations (with the possible exception of commercially sensitive information). For context, total external long-term public and publicly guaranteed long-term debt stocks in DSSI-eligible countries stood at $457.3 billion at end-2018, of which $174.3 billion owed to bilateral creditors.

The initiative, while providing welcome fiscal breathing space to participating countries in the short term, has brought to the fore systemic shortfalls in effectuating comprehensive debt moratoria to respond to global crises, such as the Covid-19 pandemic. Although the DSSI calls on private creditors to join the initiative on comparable terms, and on multilateral development banks to consider joining where compatible with maintaining current high credit ratings, the prospects of either group of creditors signing up to the DSSI have evaporated fast, for different reasons. Only half of the eligible countries under the initiative have substantive commercial debt obligations outstanding. Of these, countries with continued access to international markets mostly prefer not to jeopardize this through downgrades by credit rating agencies in the event of their joining the DSSI. This leaves only a limited number of countries with substantive commercial debt and already limited or no access to international financial markets, and thus minimal leverage on private creditors to join the initiative.[9] Multilateral development banks have argued that participation in debt suspension and relief initiatives will come at the expense of the much larger contribution to liquidity provision and enhanced fiscal spaces they can make through continued and extended provision of concessional financing (new borrowing), the so-called "net financial flow" concept (World Bank, 2020).

While the G20-Paris Club DSSI may be extended into 2021, there is a need to broaden its scope, not only through inclusion of all creditors but also in terms of country coverage to more middle-income countries in or close to debt distress, are thus unlikely to be implemented. This points to the lack of an effective international mechanism to employ automatic temporary standstills (or moratoria) at the required scale in defined disaster situations. Such a mechanism would have to go beyond the DSSI also by including provisions for exchange-rate and capital controls, debtor-in-possession financing and lending-into-arrears to minimize liquidity and solvency problems arising during a standstill.

Other proposals to implement debt relief (as opposed to debt repayments suspensions only) aim to provide fiscal breathing space speedily but with an eye on facilitating continued market access by participating developing countries. This includes Covid-19-related debt swap programmes (United Nations, 2020), debt exchange or conversion programmes (Bandeira, 2020) and voluntary sovereign debt buy-backs (Stiglitz and Rashid, 2020). Such initiatives typically involve some degree of debt restructuring or reprofiling below the threshold of full-scale restructurings following a default. Voluntary sovereign debt buy-back programmes have the advantage that they do not tie debt relief to specific fiscal expenditure and public investment plans, thus providing wider fiscal breathing space. They essentially use donor and countries' own funds to buy back their bilateral and/or commercial external debt (or some of this) at discounts in secondary markets, freeing up considerable fiscal space unconditionally. By contrast, debt swap programmes, while popular to promote specific uses of debt relief, such as climate change adaptation, SDG-related investments and Covid-19 crisis response and recovery, relegate the implementation of debt relief to private or public funds. This usually involves operating on a contract-by-contract basis to buy up commercial debt. This can be slow, costly and subject to partial interests. Similarly, debt conversion programmes (that aim to convert commercial papers for new concessional papers), and related special purpose vehicles to implement such a conversion – not unlike the "Brady Bonds" of the end-1980s/early 1990s – require protracted addressing of hold-out creditor issues, accommodation of private creditors and backing by lead central banks. Sovereign debt buy-back programmes are therefore the best option in the short term, seen from the point of view of providing unconditional fiscal space as soon as possible.

Whichever options developing countries may prefer (or any combination of these), depending not least on the composition of their external public and publicly guaranteed debt (chapter I), these all require initial funding by the international community. Re-allocation of existing SDRs to such funds, and preferably to debt buy-back schemes, should be a priority to enhance fiscal space in developing economies in any relevant timeframe.

Finally, immediate debt cancellations (as opposed to structured debt relief), in particular for heavily-indebted poorer developing economies, are also subject to debate and would free up fiscal resources in these economies on a lasting rather than temporary basis. For now, the IMF has cancelled debt repayments due to it by the 29 poorest developing countries for the period May–November 2020, amounting to around $215 million through its Catastrophe Containment and Relief Trust (CCRT).[10] An expansion of such unilateral debt cancellations by official creditors (owning the bulk of least developed countries' external debt) would require a new multilateral debt relief initiative, following the Heavily Indebted Poor Countries (HIPC) Initiative and the follow-up Multilateral Debt Relief Initiative (MDRI) of the late 1990s and mid-2000s. Given the protracted years-long nature of the HIPC and MDRI initiatives that still delivered "too little, too late", such multilateral debt cancellation initiative might not be mounted fast enough, let alone ensure meaningful involvement of private creditors, where relevant.

Even so, this remains an option that would provide the most immediately available and unconditional fiscal space to the poorest developing economies during the pandemic. In fact, unless swift action is taken in this regard, disorderly debt cancellation is more than likely to become a feature of the international debt landscape sooner rather than later, with much higher losses for all parties involved. In addition to other, less forthright, mechanisms to provide short-term debt relief (such as debt swaps, debt-buy-back programmes and debt exchanges), an internationally agreed sovereign debt restructuring workout mechanisms (SDRMs) will remain essential to address debt crisis resolutions in an orderly and fair manner and to move to long-term sustainable debt positions (chapter V).

2. Expanding fiscal space through international tax reforms

Longer-term measures to enlarge fiscal space in developing countries will need to tackle the restrictions on governments' capacity to mobilize resources that are imposed by multilateral rules and practices. These restrictions cannot be addressed adequately by any individual country alone, but rather require a fundamental redesigning of the global economic governance architecture and its multilateral rules and practices such that governments, particularly those in the developing world, are able to reclaim their fiscal space.

(a) International cooperation in tax matters instead of a race to the bottom

A critical area of action in reversing the weakening of governments' capacity to mobilize resources is

that of policy cooperation at the international level to counteract the decline in corporate tax rates. Tax competition to attract FDI has substantially reduced corporate tax rates in the last four decades, depriving governments of valuable fiscal resources. Preventing the ongoing race to the bottom in corporate taxes can only be done through international cooperation. The main reform proposal is to introduce a global minimum effective corporate tax rate. Such a tax rate, which could be set at 20–25 per cent, would simplify the global tax system and increase tax revenues of all countries (*TDR 2019*).

Policy coordination at the international level is crucial in tackling the various mechanisms employed by multinational enterprises (MNEs) for the purpose of corporate tax avoidance and evasion. Most important among these are shifting of profits to affiliates located in tax heavens, shifting of liabilities to their affiliates located in high-tax jurisdictions, transfer pricing in the form of deliberate inaccurate valuation of intra-firm cross-border transactions, and exploiting of tax loopholes in domestic tax laws and international tax treaties. The way forward is to abandon the separate entity principle which treats MNE subsidiaries as separate individual entities for tax purposes. As that is completely inadequate in today's globalized economy, a system of unitary taxation of the whole group should be adopted in its stead. The resulting taxes should be distributed across countries according to the "formulary apportionment". The criteria according to which taxes of the group would be distributed to countries in which they operate could be employment, physical assets, total sales, or a combination of several indicators.

(b) Increased transparency and greater voice in tax matters

Improvements in transparency and exchange of information for tax purposes would further reduce IFFs. An important step forward in this regard would be an adoption of a global financial register that would record the owners of financial assets throughout the world, and the adoption of registers of the beneficial ownerships of companies (Zucman, 2015). Guaranteeing public access to these registries would reduce the control and the oversight burden of tax administrations, thus greatly benefitting developing countries with limited institutional capacities. Reporting on the country-by-country distribution of core financial data of MNEs, including taxes paid, would also be important, as it would enable cross-country comparisons and detection of mismatches (Murphy, 2012).

Efforts to reduce tax evasion by MNEs should be strengthened, as these practices account for billions of dollars of foregone fiscal revenue that could otherwise be directed towards productive investment in public goods and services. However, policy and best practice initiatives are mostly led by developed economies, which are still the most significant home countries of MNEs, and remain among the leading secrecy jurisdictions, despite recent initiatives to tighten controls and improve transparency. Developing and transition economies deserve a stronger voice in international discussions and initiatives. At the same time, the influence of lobbyists and interest groups on national and international policymaking needs to be more explicitly recognized, and countermeasures adopted. In pursuing this agenda at the international level, it will be important to give a more prominent role to monitoring institutions such as the United Nations Committee of Experts on International Cooperation in Tax Matters, and to adopt a fully multilateral convention against tax avoidance and evasion (*TDR 2017*). Due to its universal membership, the United Nations is the most legitimate body to balance the voices of Member States of different size and to coordinate processes of collaboration and coordination between countries.

(c) International governance in extractive industries

The generation of public revenue from the extractive industries and their use for financing development are central to the strategies of many developing countries. Capturing a fair share of resource rents from a country's natural resources and deciding how they will be used for development is its government's responsibility, which cannot be transferred to the private companies exploiting the resources. Although several appropriate measures to that effect can be taken at the national level (*TDR 2014*) multilateral cooperation to prevent the race to the bottom via tax incentives in the extractive industries is indispensable. Transparency initiatives such as the Extractive Industries Transparency Initiative (EITI) should be made mandatory instead of voluntary. In addition, the initiative should be extended to producing firms and commodity trading companies instead of focusing only on governments. Further, changes in tax regimes and ownership structures at the national level should not be subject to legal retribution through

the existing investment dispute mechanisms which favour private-sector actors. Other proposals in this section, in particular the global minimum effective corporate tax rate and the unitary taxation of MNEs, would further strengthen international tax governance in the area of extractive industries.

(d) A revamped international tax architecture for the era of digitalization

The increasing digitalization of economic transactions is a growing cause of foregone fiscal revenue for countries across the globe. As the digital economy has expanded, the current international tax framework, based on the concept of permanent establishment, has become less and less relevant to determine where taxable value is created and how to measure and allocate it between countries. Companies without a physical presence in a tax jurisdiction regularly conduct economic activities over the Internet. Furthermore, digitalization increasingly includes economic transactions based on intangible assets, such as software, algorithms, and intellectual property. These assets are difficult to price because of their uniqueness, which makes it challenging to determine what the taxable value of a transaction is. Moreover, measurement of digital activity and the resulting profits is effectively impossible since a large part of value creation relies on users in the form of personal data and user-created content. Finally, the online purchase of goods and services complicates indirect taxation, such as the collection of value added taxes (VAT) and goods and services taxes (GST), as they are based on the destination principle. These four aspects of digital economy are fundamentally at odds with the existing tax frameworks that were developed for the traditional economy.

It would be much better to charge VAT on digital transactions either through self-assessment by the importer under a so-called reverse-charge mechanism, or through a requirement for non-resident suppliers to register for VAT purposes and to collect and remit the VAT. In the case of corporate taxation, the best reform, from the point of view of developing countries, would be to base international tax norms on "significant economic presence". This would create a taxable nexus for a company operating in a digital environment if it has a presence in a tax jurisdiction either on the supply side (physical assets, employees) or the demand side (sales, data and content input by users). An inclusion of both demand- and supply-side elements in the definition of significant economic presence would have benefits for developing countries as well, even though the vast majority of digital economy companies operating globally are from developed countries.

Reforming lopsided rules and biased government structures is the starting point of a long-overdue overhaul of the global economic governance architecture. Enlarging fiscal space is one of the crucial elements needed to ensure that a more resilient, socially inclusive, development-oriented, and environmentally sustainable global economy emerges from the Covid-19 crisis.

Notes

1 See Easterly, 2005; World Bank, 2005; Vreeland, 2003; Ortiz et al., 2015; Kentikelenis et al., 2016.

2 The general government comprises federal, state/provincial and municipal administrations. It does not include financially independent state-owned companies and the central bank. The data come from the IMF World Economic Outlook, of October 2019. The fiscal numbers for 2019 are the IMF forecasts at that time. The debt decomposition was obtained in four steps. First, the change in the net debt ratio and the primary balance came directly from the IMF series. Second, the net interest payment is the difference between the general government's net lending and primary balance. Third, the growth effect is the net debt ratio of the previous period multiplied by minus the nominal GDP growth rate and divided by one plus the nominal GDP growth rate. Fourth, the wealth effect is the residual, that is, the difference between the change in the net debt ratio and the sum of the primary balance, net interest payment and growth effect.

3 Two factors helped in this outcome: (1) Germany took advantage of the indirect subsidies to its banks provided through the loans to the peripheral countries (considered a textbook case of triangular bailout) and (2) the special conditions that applies to the obligations taken on by the public bank KfW, that do not qualify as public debt and allowed extra support for German small and medium firms.

4 The debt decomposition done in this chapter works only for net debt ratios. Since the IMF date does not include net-debt dynamics for Argentina, China, the

Russian Federation and India, we cannot do the same analysis for these economies.

5 Because of the massive exchange-rate swaps done by the Brazilian Government, part of the increase in the Government's net interest payment came from the depreciation of the Brazilian currency in 2014–15.

6 Estimating and forecasting such trends is, of course, a challenge. For instance, the way cyclically adjusted budget rules define the cycle is based on the assumption that the actual income oscillates around the potential – or normal – level. This leads to the inevitable empirical result that the potential output tracks the cycles of the economy, automatically falling when the actual income falls and thus showing a small or no room for what would then be considered sustainable cyclical deficits (Palumbo, 2013; Costantini, 2017).

7 In 1931, the fiscal adjustment thought to be necessary to defend the pound included a substantial cut in military pay, which contributed to a mutiny in the English Navy, followed by the abandonment the gold standard by the United Kingdom just a few days after the incident (Ereira, 1981). The consequences of austerity measures in Germany in the early 1930s were even more severe (Galofré-Vilà et al., 2020).

8 This lower figure is often cited to ensure congressional approval in the United States (required for any new allocation of more than about $650 billion worth of SDRs in any five-year period), and so as not to slow down international agreement.

9 The Institute of International Finance (IIF) has agreed terms of reference for voluntary private sector participation. See also: https://www.iif.com/Portals/0/Files/content/Regulatory/IIF%20Letter%20Debt%20LICs%20April%202020.pdf

10 See e.g. https://jubileedebt.org.uk/press-release/reaction-to-215-million-of-debt-cancellation-by-imf (accessed on 30 July 2020).

11 IMF Articles of Agreement XV.1 (a) on the IMF authorization to create SDRs and XVIII. 1 (a). on the general purpose of the creation of SDRs by the Fund. See Eichengreen (1996: 117-120), for the origins.

12 As of July 2020, the dollar-equivalent 'basket' exchange rate would raise this figure to $287 billon.

13 This refers to the powers of the IMF to "designate" surplus economies to acquire SDRs from deficit countries to facilitate their access to hard currencies.

14 Figures based on Plant (2020: table 1). Income groups are based on the World Bank classification.

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RECOVERING BETTER: RETHINKING MULTILATERALISM

V

A. Introduction

In addition to its immediate medical, economic and social impacts, the Covid-19 pandemic offers an opportunity to broadly rethink the system of international economic relations as it has evolved since World War Two, and particularly in the last four decades. Indeed, talk of recovering better will fizzle out without an acknowledgement of the failures of the recent past and a commitment to rewiring the rules of the global economy in support of people and the planet.

The dominant multilateral narrative pre-Covid-19 was one of steady improvement in the liberal international order from 1945 through the abandonment of fixed exchange rates in the 1970s, the opening up of developing countries following the debt crisis of the early 1980s and the collapse of the Soviet block as that decade ended, to the creation of the WTO in 1995, the emergence of the Euro and the integration of China and other emerging economies in to a world of increasingly complex global supply chains. As the numbers in extreme poverty began to drop in the new millennium, the rise of the BRICS was heralded as the beginning of a truly multipolar world. For some, history had come to an end, and centuries of boredom lay ahead (Fukuyama, 1989).

The GFC darkened this rose-tinted narrative but it proved resilient; Brexit and the emergence of virulently nationalist leaders caused subsequent bouts of anxiety but have been treated as a cultural aberrations or episodes of disinformation. But this tale resolutely brushes aside fragilities and stresses in the international order that have been building for over two decades, and the crises of the last decade are at least in part a result of them, not sudden events that, in defiance of logic, appear from nowhere.

Nor has the Covid-19 crisis appeared from nowhere. It has its roots, in part, in an extractive growth model that has extended to the way we manufacture food, privileging cost-cutting and short-term returns at the expense of long-term investments and a commitment to the needs of future generations. It has, moreover, exposed the full extent of the economic divide that continues to separate the developing from the developed world. Another lost decade for many developing countries and regions is a distinct possibility but there are also many communities across the developed world that are now contemplating a similar future.

Developing countries, as discussed in chapter I, have already faced an unprecedented turnaround in capital flows triggered by a global financial panic in early March, in many cases before the novel coronavirus actually crossed their borders. A sharp drop in export earnings generated a vicious deflationary spiral and heightened debt distress across much of the developing world. Extreme poverty is again on the rise along with an increased incidence of hunger and malnutrition. Health services are collapsing even in middle-income developing countries. And choosing whether to work or to stay at home is simply not an option where informality is an overriding feature of economic life.

The year of Covid-19 is the perfect time to evoke the spirit of multilateralism that inspired policymakers after the horrors of World War Two, and to remind ourselves what has been lost since then. “Economic diseases are highly communicable”, the United States President Franklin Roosevelt said in his opening address to the Bretton Woods conference. “It follows, therefore, that the economic health of every country is a proper matter of concern to all its neighbors, near and distant. Only through a dynamic and a soundly expanding world economy can the living standards of individual nations be advanced to levels which will permit a full realization of our hopes for the future.”

The world's richest economies have come face-to-face with a system that they constructed, and in ways which allowed them to pick and choose the rules and principles that best suit their own economic interests but now demonstrates a fragility they could hardly have imagined only a few years ago. Supply chains have ruptured, generating shortages of essential medical equipment, protective gear, and active ingredients in key medicines, while leaving suppliers unpaid. Corporate governance models that emphasized cost-cutting in the name of vibrant quarterly earnings manifestly lack resiliency. Notions of "strategic autonomy" – denied to developing countries under an endless invective against politically inspired distortions of free markets and praise for the virtues of competition – are no longer taboo.

The Covid-19 crisis has also exposed the downsides of a financialized world caught up in the frenzied buying and selling of existing assets, dependent on an endless flow of debt and steeped in a culture of moral hazard. For the third time in just two decades, leading central banks have felt the need to prop up financial markets on a massive scale to save a flawed economic model that is generally recognized to have increased inequality and undermined democracy.[1] The investor class has done well in 2020, billionaires have added to their fortunes, large firms have enjoyed the largesse of central banks and powerful digital monopolies have fortified their position.

Policymakers in advanced economies have, in the face of the current crisis, been willing to consider a whole range of taboo-breaking measures to stabilize and safely unlock their economies, though for how long remains an open question. The voices of Keynes, Lerner, Polanyi – heard only at low volume in recent decades – have received long-overdue amplification. Change is in the air: tax and spend is getting a fresh look; industrial policy has made a comeback; support for a universal basic income, a jobs guarantee and functional finance, have all received a hearing in high policy circles. Whether or not this signals a wider sense of "togetherness" and a commitment to "radical reforms […] to forge a society that will work for all", in the words of the *Financial Times*,[2] however, is still an open question. This is particularly true at the international level; the idea of a global society of mutual responsibility for peace and prosperity that galvanized world leaders some 75 years ago seems an increasingly distant dream.

There is still a lingering recognition that an effective response to a global health pandemic requires collective action and coordination at the global level. However, the multilateral system tasked with that purpose, has, particularly since the GFC, been struggling to demonstrate its effectiveness and retain its relevance. Whether or not the current crisis pushes that system closer to the brink of implosion or begins a new chapter of international cooperation rests on changing political currents in the leading economic powers. What seems certain, however, is that avoiding a doomsday scenario will require planning for a different future while tackling the current crisis, in all its dimensions. The original architects of multilateralism at the end of World War Two had no shortages of immediate problems to solve even as they set about building a better future, and given the scale and depth of the Covid-19 crisis and the unresolved issues that preceded it, the world's dominant powers must rise to the challenge.

That said, a renewal of the ambition of 1945 was promised, but not delivered, in response to the GFC only a decade ago. Instead, once abundant injections of government resources had stabilized the financial system, talk of a new economic order was quickly forgotten in favour of a return to business-as-usual with the underlying inequalities and fragilities that caused the crisis still in place. With the threat of environmental breakdown intensifying over the last decade and the current crisis adding new stresses, failure to plan for the future this time around will quickly foreclose on any hope of recovering better.

The previous chapters have mapped out the current state of the global economy in the face of the Covid-19 shock, warned of the possibility of a lost decade, that will extinguish any hope of meeting the Sustainable Development Goals by 2030, and presented the case for a different kind of recovery based on an ambitious strategy of reflation, redistribution and regulation. That this will require a more active State and a wider space for public action, at both the national and international levels, goes without saying.

The intellectual stakeholders in hyperglobalization are already fighting back against the prospect of change. They have raised the objection that the presumptive gains from "free trade" – whether measured in increased efficiency, cheaper consumer goods or poverty reduction – will be sacrificed to unchecked state intervention and a retreat to nationalist agendas and beggar-thy-neighbour policies. Warnings about the profligacy of the public sector and the bugbear of rampant inflation are already being sounded. Indeed, if history is any guide, as soon as talk of managing

globalization in a more just and equitable manner arises, the standard, and increasingly hoary, neoliberal trope of "the State versus the market" surfaces immediately.

A combination of retrenchment and reglobalization would be a disaster for people and the planet, even assuming that this was pursued less aggressively than after the GFC. Instead, what is needed is "a more collective system of international cooperation, whereby the division of the world into areas of poverty and plenty may be banished and prosperity achieved by all; and to find ways by which the human and material resources of the world may be harnessed for the abolition of poverty everywhere and *the restoration of environmental health of the planet"*. This (excluding the italicized final clause) was what countries accepted as the challenge facing the international community when UNCTAD was founded in 1964. We need to recover that spirit.

Given that healthy lives and livelihoods anywhere are now much more dependent on economic, epidemiological, and environmental forces everywhere, recovery cannot be achieved in one country at a time. International cooperation and coordination are essential to recovering better. But the response from the multilateral system has, to date, been diluted and fragmented – a long way short of what is needed, particularly for developing countries where an estimated financial shortfall of $2-3 trillion risks tipping them in to another lost decade (UNCTAD, 2020a).

Reviving multilateralism cannot, however, be pursued simply as an exercise in nostalgic reversion. There were serious weaknesses and significant gaps in the workings of the post-war system that emerged from the deliberations at Bretton Woods and San Francisco, particularly for developing countries. Moreover, both developed and developing countries integrate in to today's international division of labour differently than they used to, while the geo-political axis of international relations has tilted towards East Asia where a fast pace of capital formation, the extensive use of industrial policy and a more strategic approach to integration have been abiding (albeit evolving) features of a mixed-economy model in countries from the region. Still, given the multiple systemic challenges we are currently facing, this is not the time – as Dr. Martin Luther King, Jr. put it to a world facing the entrenched legacy of racism, militarism and endemic poverty – "to engage in cooling off or to take the tranquilizing drug of gradualism".

The next section examines, briefly, the history of multilateralism with particular attention to the circumstances in advanced economies that made its emergence in 1945 possible, the gradual assertion of developing-country voices in its structure, and the eventual hollowing out of its original intentions, beginning in the 1980s, as the financial system slipped its fetters. In section C, we discuss how the forces of what we call, with no small hint of criticism, *hyperglobalization* were already exposing fissures in the multilateral system before Covid-19 brought them dramatically to light. In the final part, section D, we suggest reforms to the multilateral architecture that would manage a safe retreat from hyperglobalization without inflicting the costs we associate with the events of the 1930s, build principles into the system in line with the Agenda 2030, and establish a more democratic, less hegemonic model of global governance.

B. Multilateralism: A fractured history

Globalization, understood as the ever widening and more frequent interaction of human activity beyond a well-defined territorial space, has been a feature of social existence for many centuries. However, its contemporary economic form is closely linked to the rise of nation States. As those States became more closely interdependent, forms of cooperation and coordination have emerged to deal with conflicts amongst them and to manage common challenges.

Utopian thinkers of the 19th century saw in a series of ad hoc international conferences – on health challenges, new communications technologies, and food security – the germination of a world without national borders (see Box 5.1). They were largely ephemeral exercises and the supporting structures that did emerge (like the International Telegraph Union in 1865) were small and lacked wider political backing and influence. World War One changed the nature and scope of multilateral ambition. Permanent institutions emerged from the post-war settlement with the creation of the ILO and the League of Nations as fully fledged secretariats tasked with enforcing the peace and helping to recover the stability of the pre-war international order.

BOX 5.1 Multilateralism: an elusive idea

The search by people everywhere for security, dignity, inclusion and prosperity has long rested on the institutional foundations of the nation State, and still does to a large extent. As such nationalism – generally understood as the ideological glue of an imagined community tied to a specific place whose security and prosperity rests on a shared body of rules and norms upheld by a set of state institutions – is hard-wired into contemporary human experience (Ralston Saul, 2005). But nationalism does not exist independently of internationalism, which involves the economic, political and cultural interaction of different nation States. Both nationalism and internationalism can have a positive (inclusive and collaborative) or a negative (exclusive and oppressive) connotation with the outcome hinging less on matters of identity and more on relations of power, within and across countries.

Multilateralism is a particular form of institutional engagement designed to meet common challenges that arise in an interdependent world. According to international relations scholar, and former United Nations official, John Ruggie (1992, p. 571), "multilateralism is an institutional form which coordinates relations among three or more States on the basis of 'generalized' principles of conduct […] without regard to the particularistic interests of the parties or the strategic exigencies that may exist in any specific occurrence". More simply, multilateralism is an attempt to establish a public realm at the international level in ways that do more than simply sum the actions of individual States. For this to happen those States must willingly cede some of their authority and legitimacy to international institutions and agree to abide by whatever collective actions these institutions advance to meet common challenges.

Taking its cue from the public realm at the national level, multilateral challenges are often described as public goods, such as peace and security, economic stability and a healthy and educated citizenry, where "free-riding" by any one country can dilute or undermine the efforts of others to deliver on the desired goal. Accordingly, some ceding of sovereignty to an international body with the requisite technical skills to identify the challenge and offer possible solutions is deemed necessary if these *global public goods* are to be provided and maintained.

Providing global public goods does not, however, exhaust the catalogue of possible multilateral challenges. Protection of common resources, both natural (such as the atmosphere and oceans) and social (such as knowledge and heritage), which should be available to all suggests that there are *global commons* that, if left unmanaged, can be rendered scarce and plundered or abused by predatory forces. On this more contested terrain, involving weaker and stronger players, only international stewardship and cooperation can ensure fair outcomes.

The boundaries of the public realm are no more fixed in perpetuity at the international level than they are at the national level. In both cases, those boundaries are determined by rules, principles and norms that determine which challenges should be given priority, what policies and instruments should be employed to meet them and how any associated costs and benefits are distributed. Whether, and if so how, international cooperation and coordination might help to meet such challenges introduces an ideological dimension to the framing of *global public policy*.

The design of institutions to manage these collective challenges, and the principles they should adopt to do so, has been an abiding discussion over two centuries with efforts to advance a multilateral agenda intensifying after periods of extreme disruption and conflict. Particularly in the 20th century, massive wars had this effect because they involved much more than military mobilization, as did economic crises, which caused unprecedented levels of distress. Attitudes towards the use of public resources and to the structure and operation of public institutions and policy shifted accordingly.

Three different visions of multilateral governance have evolved in the process (Mazower, 2013). A constitutionalist vision, in which nation States lose much of their sovereign power or (in their most utopian interpretations) wither away altogether, in favour of some form of supranational authority responsible to the global community and guided by strong moral convictions and legal opinion. A more technocratic vision which rests on the presence of an international bureaucracy dedicated to an agreed set of universal rules and principles and armed with the requisite technical knowledge and expertise that allows it to arbitrate between member States, and foster cooperation between. A final, more political, vision rests on the presence of hegemonic power that takes responsibility for coordinating collective actions while demonstrating some degree of self-restraint and benign stewardship that tempers its own interest and influence.

These visions of multilateralism are, of course, more ideal types than historical descriptions. Indeed, multilateralism in practice has always been a hybrid, whereby a dominant power has been willing and able to coordinate collective actions while allowing the space for international expertise to operate and for international institutions to acquire sufficient authority to provide a (partial) counterweight to its own influence and authority.

The world of collapsed empires, insecure States, shifting economic power relations and growing political tensions was, however, hardly the right environment to get the feel of international cooperation in pursuit of common goals, let alone for improving working conditions. Moreover, while the League was tasked with advancing the liberal international economic creed, it was, in truth, never designed, administratively or ideologically, to manage the imbalances and trade-offs bequeathed by the war and in particular the deep (and interconnected) economic and political fissures opened up between heavily-indebted and creditor countries and their related distributional struggles.

The League was almost immediately faced with a growing humanitarian crisis, which combined public health disasters (from the global flu pandemic, to the spread of typhus) and refugee crises (particularly in Eastern Europe and the Middle East), and a series of economic shocks (particularly in Western and Central Europe). On the health front, the League steadily built up a reputation for independent expertise and information gathering, and forged a widening mandate (Mazower, 2013).[3]

However, its efforts at economic recovery were a good deal more circumspect. Ideologically, the League was committed to "reglobalization" following the collapse of trade and capital flows during the war; a return to the gold standard; fiscal austerity, central bank independence and labour market flexibility were the chosen instruments.[4] International conferences, mostly organized by the United States as the largest creditor, dealt with the main economic problems of the day. That strategy rested on an ingrained sense of pre-war predictability and stability – a great moderation dating back to the 1870s – derived from the infallibility of market forces and the virtues of the gold standard not only as a check on government action but a moral compass for policymakers.[5]

Pre-war economic stability was, however, not so much the product of autonomous market forces but more due to the political stewardship of an industrial powerhouse, Britain, backed by the resources of an empire with deep financial markets and a powerful navy. By the second half of the 19th century, Britain was willing and able to provide the structural underpinning of a stable international currency system linked to gold convertibility, free-flowing capital and an informal coordination network, orchestrated through the Bank of England, able to mobilize significant resources on a temporary basis in response to unforeseen shocks that might otherwise threaten systemic stability (Eichengreen, 1996).[6] With the United States unwilling to assume that role after 1918, the League was never in a position to substitute for the lack of coordination among the major players and prevent disruptive economic imbalances and deflationary pressures at the national level spilling into the international realm and back again (Temin and Vines, 2013: chapter 2).

1. The inter-war years: From reglobalization to building back better

The stumblings of the League were finally ended by the Great Depression. The 1933 World Economic Conference in London, with the League as its acting secretariat, was the last throw of the post-war liberal internationalist dice in a game that the newly elected President of the United States had already decided to abandon. Although Roosevelt's cabinet contained a mixture of liberal internationalists and New Deal transformers it was the latter who offered concrete solutions to the cardinal economic problem of mass unemployment.

Roosevelt understood that the economic transformation needed to conquer mass unemployment would not only have to begin at home but would require a different kind of State than the one that he inherited from his predecessor and a different set of economic policies from those promoted by footloose capital (Katznelson, 2013: chapter 7). While national economic recovery took priority over international economic stability, the New Deal was not a simple turn to isolationism but rather a radical programme to reshape the public realm both domestically and internationally (Patel, 2016: 4). In fact, the Roosevelt administration was quick to reengage internationally following its departure from the gold standard in June 1933, beginning with the United States joining the ILO in 1934, through the passing of legislation allowing for reciprocal trade agreements under presidential decree and a less militaristic stance toward countries in Central and South America.

By the time of Bretton Woods in 1944, the United States had further consolidated its dominant economic position, thanks to its relatively strong recovery from the Great Depression and booming wartime economy. Also, institutionally, politically and ideologically it was in a position to assume a hegemonic role, and one rooted neither in a free trade nor a colonial past, and with the wings of finance decisively clipped.

In particular, the New Deal, from its inception, was built around the idea of "interdependence" which Roosevelt defined as "our mutual dependence one upon another – of individuals, of businesses, of industries, of towns, of villages, of cities, of states, of nations" and which was in turn closely linked to a commitment to "fraternity, or mutual responsibility or the understanding of social justice" (Rauchway, 2018: 105-106). This vision of the policy challenge seen through a bifocal lens of interdependence and social justice was extended to the international realm at Bretton Woods (and the following year to a fully-fledged United Nations).[7]

The negotiations at Bretton Woods were, inevitably, a good deal less idealistic (Conway, 2014), but the institutional prerequisites for a stable international financial order were put in place – through a system of pegged but adjustable exchange rates, capital controls and balance of payments support – and some basic principles for managing an interdependent economic order were agreed. The need to avoid imported deflation and the threat of beggar-thy-neighbour policies, support for economic and political sovereignty through reliable access to international public finance for productive investment, and the disciplining of economic aggression by big States and powerful private actors were three basic precepts (Morgenthau, 1945).

These principles were, needless to say, not the only ones shaping the post-war multilateral agenda. In the United States, vested interests were pushing back against the New Deal as the war economy was winding down. Business interests mobilized against the regulatory controls of the International Trade Organization agreed in Havana in 1947 and banking interests (absent from the Bretton Woods negotiations) began to gain a foothold in the World Bank.

The evolution of the multilateral system after 1945 thus reflected a disjointed amalgam of utopian, technocratic and hegemonic forces. However, its core principles did provide a rough template for developing the world's resources, coordinating the actions of its major players and supporting the policy goals of full employment and a fairer distribution of income in advanced economies. By contrast, the needs and ambitions of developing countries struggled for attention and as more countries achieved political independence there was a growing determination to employ these same principles in support of accelerated economic development, particularly through fairer trade relations and financing for long-term investments.

UNCTAD was established in 1964 to advance the goal of "prosperity for all" and backed by strong leadership and a sense of solidarity. A more fully inclusive multilateral vision emerged around the idea of a "new international economic order" which would, working through the United Nations rather than the Bretton Woods institutions, introduce new rules and practices to address structural biases in the international division of labour, particularly with respect to control over natural resources, access to technology and the market power of large international corporations.

The timing seemed right. From the early 1970s, as the advanced countries struggled to manage a series of sharp economic shocks and heightened distributional conflicts, the political solidarity of the South combined with poles of rising economic strength – particularly the oil-exporting developing countries who found themselves with large trade surpluses while other developing countries enjoyed access to cheap finance as petrodollars were recycled though syndicated bank loans – pushed the multilateral system in a more inclusive direction. The moment, however, proved short-lived.

2. The world turned upside down

The subsequent hollowing out of post-1945 multilateralism began with the emergence of markets beyond the purview of domestic regulators and the mandate of international bureaucracies. These went by the innocuous name of Euromarkets; established partly to allow the Soviet Union and China access to foreign currency, these became the vehicle of choice for banks of the United States and international corporations to circumvent domestic financial regulations.[8] They also helped establish a wider fledgling network of opaque institutions that eroded the oversight of national authorities over fiscal matters, corporate pricing behaviour, accounting practices, etc.

Just as importantly, pursuit of domestic policy of the United States came into conflict with its hegemonic role as a guarantor of international economic stability. With the dollar's convertibility in to gold at a fixed rate as the lodestar of the system, the paradox that its stability depended on countries foregoing their right to convert the dollars they accumulated as reserves in to gold, became increasingly difficult to ignore. The war and social spending of the United States drove a dollar crisis, and institutions established at Bretton Woods to manage a system of pegged exchange rates cracked – with fateful results when the Nixon

administration suspended the convertibility of the dollar into gold. Economic dominoes fell, and the inflation of the 1970s was the result.

High interest rates emanating from the Federal Reserve under chair Paul Volcker had the stated aim of tackling inflation. But the persistence of high rates even after inflation had passed its peak signalled a more profound shift away from a world where corporations made their money from producing and exchanging goods, to one where they did so from producing and exchanging knowledge and financial assets. Warning of renewed "pressures to turn inward", Volcker promoted fiscal discipline as the only assured way to preserve stability in an open economy. The voice of organized labour was slowly silenced, the voice of Wall Street became ever louder (Mazower, 2013).

The "controlled disintegration" of the post-war economic order that followed the sharp rise of interest rates had profound effects. Developing countries, seeking a bigger role in the post-war multilateral project instead faced a deep debt crisis and a lost decade of economic retrenchment and diminished state capacity. Policy coordination became the domain of leading central banks and distributional outcomes the domain of presumptively free markets; competition was promoted as the guarantee of efficient and stable outcomes, lower corporate taxes as key to a business-friendly environment and flexible labour markets as a way to deliver the profits needed to fund productive investment.

The Bretton Woods institutions, having lost their original *raison d'être* as guardians of an international financial system against destabilizing capital movements, became instead the framework by which a very different multilateral agenda took hold. Global governance now aimed to curtail national sovereignty and extend and protect the rights of international market actors, particularly those of footloose capital, through open capital accounts. Accelerated trade liberalization levelled the playing field for international corporations, and was consolidated at the multilateral level through the expansive Uruguay Round in the early 1990s, which went far beyond tariff reduction and applied equally, after a short grace period, to even the poorest countries (*TDR 2018*; Davis, 2019). Regional and bilateral agreements that reached deeply into domestic regulation hinted at what the entire world might eventually experience.

C. The antinomies of hyperglobalization

Already by the 1990s, there were signs that sharply rising inequality and localized financial shocks could pose a threat to the stability of the global economy (*TDR 1997*). The GFC offered a chance to recover better. Instead, the dominant policy approach remained a "persistent fealty to so much of the pre-crisis conventional wisdom." (Wolf, 2018). Much like the "return to normalcy" after 1918, fiscal austerity, lower taxes and labour market flexibility framed the approach to recovery once financial markets had regained stability. Governments were encouraged to boost exports and attract FDI as sources of long-term growth with further liberalization measures pursued through free trade agreements.

The financial system remained largely intact albeit with some tightening of regulation and a further shifting of financial activities towards the less regulated "shadow banking" sector (White, 2020). And, again with parallels to the 1920s, multilateral institutions were sidelined, with coordination left instead to more ad hoc arrangements, notably through an empowered G20, and regional organizations. However, unlike the United Kingdom in the 1920s, the United States retained its hegemonic role, with the Federal Reserve extending its lender-of-last-resort facilities beyond its own territorial jurisdiction, albeit selectively (Tooze, 2018).

In the immediate aftermath of the GFC, the G20 helped coordinate large stimulus packages and fend off tariff-based trade conflicts (Bems et al., 2013; *TDR 2016*). But the trade measures and the support packages adopted in response to the Covid-19 crisis have, to a large extent, reflected narrower national interests. Several countries have introduced export constraints on essential health and food items and supported measures aimed at localizing production. As discussed in chapter I, massive relief packages have been adopted in response to the lockdown. However, the coordinated approach adopted by the G20 leaders a decade ago has not reappeared (Brown, 2020). And even when the leading G20 countries have acknowledged the extent of the combined health and debt calamity facing developing countries, they have shown little appetite for debt relief on a scale

commensurate with the problem, and none for taking on their own private creditor interests (chapter IV; UNCTAD, 2020b).

The increased volume and direction of goods and services across borders over the last four decades did not itself remake the multilateral system. That role was played by the unleashing of finance capital. The current crisis of multilateralism reflects less an abrupt ideological break with an open global economic order than it does a backlash to the decades-long, gradual bending of rules and practices to the advantage (and increased profitability) of footloose capital and large corporations located predominantly in the advanced economies, oftentimes with backing from their home States (*TDR 2017, 2018*).

The reorientation of multilateralism to support a hyperglobalized world bears some responsibility for the heightened inequality that has become a hallmark of the current era,[9] has fomented a push-back against globalization in parts of the developed world,[10] and has contributed to a diminished trust in the governance of international trade (*TDR 2014, 2018*). Many individuals and countries lack the skills and resources to grasp the new trading opportunities it has offered, and even properly equipped individuals will not earn a fair share of the benefits from globalization if the underlying rules are rigged against them (*TDR 2017*; Stiglitz, 2019).

In the last few years, tariff hikes and other trade-reducing policies have heightened trade tensions between the United States and China, while the United States has disarmed the WTO dispute settlement system. Now, suggest some observers, a policy overreaction to the Covid-19 crisis, combined with a failure of international leadership, could accelerate a "deglobalization" trend, with ominous warnings about a resemblance to the 1930s (Irwin, 2020; Baldwin and Evenett, 2020).

From this perspective, state action in response to Covid-19 threatens to halt the march towards ever deeper trade integration, and splinter the open, rules-based global economic order established over the previous 75 years (e.g. Berden et al., 2020; Paulson, 2020; Irwin, 2020). Yet the forces tugging at the integrity of the multilateral trading system, unleashed as a result of its neoliberal turn, have been building for years, if not decades.

1. Fragmenting supply chains

Much of the recent alarm over deglobalization during the Covid-19 pandemic stems from the sharp plunge in global trade and FDI during the second quarter of 2020 (chapter I). However, an inflection point in global trade and FDI had already occurred around the GFC. Global trade in goods and services had registered an annual rate of growth of 7 per cent between 2000 and the GFC, before collapsing and sharply rebounding between 2008 and 2010. Since then trade has ebbed and flowed around a significantly lower average figure of 3 per cent: anaemic growth in 2012–2014, a slowdown in 2015 and 2016 giving way to a rebound in 2017 and 2018, followed by a sharp decline in growth for 2019. Particularly noteworthy is that the slowdown of 2015 and 2016 occurred alongside positive and higher global real output growth, an unprecedented combination in recent times (UNCTAD, 2020c).

The current downturn follows several years of negative or stagnant growth of FDI and compounds a longer-term declining trend that also set in around the GFC. More importantly, greenfield FDI (the establishment of new productive capacity) in developing countries has not increased significantly for more than a decade and remains largely concentrated in extractive industries (UNCTAD, 2020d). This has important implications given that greenfield investments are far more meaningful carriers of potentially beneficial forces for economic development than are flows related to mergers and acquisitions or intra-firm financial flows and profit shifting, both of which are misleadingly classified as investment in the statistics.

In addition to developmental impacts, FDI is often sought as a stable source of external financing that supplements domestic resources. Indeed, developing countries with chronic current-account deficits and large external debts often look to attract FDI as a source of financing that does not entail fixed re-payment obligations. However, FDI does entail income payments in the form of remitted profits, royalties, and licence fees. These payments can cause net financial transfers on FDI to be negative, particularly when inward FDI becomes significantly lower than in previous years, while income payments need to be made on a large existing stock of FDI. Countries with a long history of FDI inflows, and hence a relatively large stock of foreign capital, are most susceptible to the risk of negative net transfers, while countries with a relatively recent

TABLE 5.1 **Net financial transfers on foreign direct investment, selected developing countries, 1990–2019**

		Ratio 1990–2008	*Ratio 2009–2019*			*Ratio 1990–2008*	*Ratio 2009–2019*			*Ratio 1990–2008*	*Ratio 2009–2019*
1	Algeria	3.21	3.82	11	Peru	0.84	1.22	21	Philippines	0.65	0.69
2	Nigeria	1.42	3.25	12	Korea, Rep. of	0.67	1.17	22	Mexico	0.34	0.63
3	Thailand	0.55	1.70	13	Argentina	0.49	1.02	23	Brazil	0.40	0.52
4	Bolivia (Plurinational State of)	0.48	1.67	14	Indonesia	1.81	1.00	24	Kenya	0.69	0.51
5	Côte d'Ivoire	1.22	1.66	15	Chile	1.07	0.93	25	India	0.40	0.49
6	Russian Federation	0.80	1.63	16	Bangladesh	0.85	0.90	26	Zambia	1.09	0.44
7	Malaysia	1.31	1.57	17	Egypt, Arab Republic of	0.10	0.89	27	Ghana	0.14	0.41
8	South Africa	1.10	1.57	18	Colombia	0.53	0.78	28	Jamaica	0.61	0.31
9	Pakistan	0.64	1.55	19	Morocco	0.30	0.76	29	Turkey	0.14	0.24
10	Tunisia	0.70	1.25	20	Costa Rica	0.62	0.69	30	China	0.30	n.a.

Source: UNCTAD secretariat calculations based on IMF *Balance of Payments* database.
Note: Net transfers on FDI expressed as the ratio of cumulative FDI-related income payments to cumulative FDI inflows. Algeria: 2005–2017; China: 1990–2004; Côte d'Ivoire: 2005–2018; Ghana: 1990–2018; India: 2001–2019; Jamaica: 1990–2018; Malaysia: 1990–2018; Peru: 1990–2018; Russian Federation: 1994–2019; Thailand: 2001–2019; Tunisia: 1990–2018; Zambia: 2000–2019. Ranking according to numbers for 2009–2019.

history of FDI-inflows and countries with continuously high, or even rising, FDI-inflows are less exposed to this risk.[11]

Measuring the sign of net financial transfers on FDI by the ratio between inflows of FDI and FDI-related payment outflows and comparing these ratios for the period 1990–2008 and the period 2009–2019, i.e. following the GFC, when the trend decline in FDI started, shows two interesting features (table 5.1). First, about half of the 30 developing countries in the table recorded a ratio larger than one during the post-GFC period, indicating that they experienced net payment outflows since 2009. Many of these countries are commodity exporters (e.g. Algeria, Nigeria, Russian Federation) that may have experienced a decline in FDI-inflows because of the decline in global commodity prices since 2011, while other countries (e.g. Malaysia, Thailand) have a long history of FDI-involvement and therefore large existing FDI-stocks.

By contrast, the ratio of payment outflows to new FDI-inflows is low in countries with a more recent history of FDI, such as India and Turkey, as well as for China for which data are available only for part of the pre-GFC period when China was just starting to become a favourite FDI-destination. Second, the ratio for the post-GFC period is higher than for the pre-GFC period for the vast majority of the countries in the table. The few exceptions (e.g. Chile, Indonesia, Jamaica, Kenya, Zambia) comprise those countries that, for reasons specific to these countries or the main commodity that they export, succeeded in maintaining, or even increasing, the level of their pre-GFC FDI-inflows. Taken together, these two features indicate that deglobalization in the form of declining FDI could well contribute to the external payments problems that many developing countries are facing in the post-Covid-19 period.

The alarm over deglobalization from shrinking trade and FDI has been compounded by growing

concerns that the disruption of GVCs from Covid-19 may persist beyond the crisis. Calls for a reshoring of critical medical and food products to take back control of strategic production processes (e.g. Lighthizer, 2020) have combined with observations that Covid-19 might include a shortening of supply chains and a more general reshoring of production to developed countries in an effort to make supply more robust and resilient (e.g. Javorcik, 2020; Auerback and Ritch-Frel, 2020). In fact, such efforts were already underway following the global trade collapse in 2009 that – combined with the floods in Thailand and the earthquake in Japan, both in 2011 – highlighted the riskiness and fragility of supply chains focused on cost effectiveness and just-in-time delivery (e.g. Korniyenko et al., 2017; UNCTAD, 2020d). Increasing labour costs in China, new digital technologies, and concerns over environmental sustainability have only reinforced these concerns.

The fact that trade growth has slowed even relative to sluggish global output growth may indicate that the world economy has run into a peak trade constraint. Taking a longer historic perspective indicates that the ratio between trade and output varies over time and that the period from the early 1990s to the 2008 crisis was exceptional, driven by the creation of NAFTA, the post-communist transition in Central and Eastern Europe and China's re-entry into the global economy, along with the expansion of supply chains as the dominant mode of organizing international production processes (Irwin, 2015).

In this context, it is important to note that supply chains have never been truly global but heavily concentrated in three regions of the global economy and in particular sectors. Regional supply chains have always prevailed in commodities, where raw materials from developing countries are sent for processing and final use to geographically close developed countries, even though rapidly rising demand from China has introduced a more global component into commodity supply chains since the early 2000s. Network analyses show that trade for all goods and services strongly relies on three regional supply hubs, organized in Europe around Germany, North America around the United States, and Asia around China, which has replaced Japan as major gravitational force in Factory Asia (*TDR 2018*: figure 2.5).

Truly *global* value chains are limited to labour-intensive industrial sectors, such as textiles and apparel, where a significant share of global production has been undertaken in China, but where rising labour costs are leading large parts of labour-intensive production activities to shift from China to other offshore locations, particularly countries in South-East Asia. By contrast, in more technology-intensive sectors, such as information and communications technology, a preponderance of European, North American and Asian hubs has prevailed, despite an increased importance of China's role in intermediate stages with links to both the European and the North American hubs (WTO, 2019).

However, enduring trade and technology tensions between the United States and China and a greater pondering of concerns about national security and technological leadership in business decisions may well spur nearshoring and further increased regionalization of supply chains in technology-intensive sectors. Turning those concerns into policy would reinforce more general regionalization forces related to policy environments emphasizing regional integration and a push towards supply resilience through shorter chains that can be governed more easily by developed country lead firms.

While the spread of supply chains has allowed more developing countries to participate in the international division of labour, drawing on their reserves of low-wage labour, that participation has been confined to a very narrow set of links in these chains and has rarely allowed them to diversify in to higher productivity activities, whether through technological upgrading or positive spillovers from the lead firm. As shown in *TDR 2018*, trade patterns strengthened the economic weight of extractive industries, whose share in aggregate domestic value added exported by developing countries rose from 1995 by almost 9 percentage points to reach 20.5 per cent in 2011. China has managed to increase its share of manufacturing domestic value added in gross exports; that share fell or increased significantly less for the other developing countries.

Moreover, the spread of low-productivity assembly lines across developing countries has not just contributed to suppressing the wages of manufacturing workers in developed countries but have also exacerbated the income gap between manufacturing workers and owners of capital in developing countries. Much of this income gap arises from the fact that multinational enterprises tend to relocate only their least productive activities to developing countries, while they keep knowledge- and capital-intensive activities in their home countries. Combined with the lopsided governance structure and bargaining power

of firms in supply chains, this relocation pattern has given rise to the frequently observed feature of the division of labour between developed and developing countries associated with supply chains, where developing countries see a creation of fabrication activities that sizably exceeds that of knowledge-intensive activities, which demand higher wages, with China being the major exception (e.g. Buckley et al., 2020).

Meanwhile, GVC-expansion has been an ideological game-changer for trade policy. As lead firms assemble intermediate inputs from various destinations, all suppliers must respect the same technical and product standards and meet exacting delivery times. This feature of corporate governance has been used to push trade policy to become increasingly concerned with non-tariff measures and engage in behind-the-border liberalization and the harmonization of regulations and standards, often codified in bilateral or regional trade agreements, and accelerate the liberalization drive behind the cover of facilitating trade and investment. In the process, the policy space available to countries, particularly for developing countries, to manage their integration into the global economy in line with local needs and conditions has diminished further.

In an attempt to use Covid-19 to press for ever deeper liberalization and harmonization, various scholars (e.g. Baldwin and Evenett, 2020) have tied calls for "reglobalization" to the need for increased digitalization of supply chain logistics to ensure transparency along the supply chain. Doing so may be a key condition for developing country firms to remain included in supply chains and, it is assumed, will help increase their share in total value added by reducing transaction costs and eliminating middlemen. However, the digitalization of supply chains would also reduce their governance and monitoring costs, thereby enhancing centralized coordination and control. This would further strengthen the bargaining power of lead firms, which are, in most part, from developed countries.

Moreover, the use of digital technologies reinforces the role of intangible assets in pre-production stages, such as in R&D and design, as well as in post-production stages, such as in marketing and use of customer data, which tends to further augment the concentration of value added at the extreme ends of the value chain and in a few developed countries. One reason for this increased risk of concentration in digitalized supply chains is the growing role of large digital corporations and global platforms, particularly from the United States, that provide the enabling infrastructure and digital services (*TDR 2018*). Covid-19 may well give further impetus to the growing role of global digital platforms, as electronic commerce and digital platforms with the widest reach are widely expected as being among the winners of the pandemic, as further discussed below.[12]

Concentration of value-added in developed country firms will be further reinforced by reshoring of the production stage of the manufacturing process, where low-skilled workers in developing countries are replaced by robots in developed countries. These concentration tendencies may be particularly strong in high-tech industries where transparency-related economic imperatives combine with geopolitical and technology supremacy issues, leaving only low-tech industries with little productivity potential to developing countries.

2. The endurance of rent-seeking

The concentration of gains from digital trade in a few large corporations is an extreme example of a wider tendency of increasing rent-seeking behaviour emerging from the rules of hyperglobalization. Rent-seeking behaviour describes the ability to capture income through the ownership and control of existing assets or from a dominant market position, rather than from productivity gains based on innovative activity or the productive deployment of a scarce resource that adds to output. A range of studies attribute growing market concentration to the rise of "superstar firms" that benefit from the rise of superstores and e-commerce and the ensuing increase in the price elasticity of consumption (e.g. Autor et al., 2017) or from changed production structures towards a greater importance of high-technology sectors where economies of scale and network effects from intangible capital and digital technologies make it difficult for newcomers to compete with the few and rapidly growing incumbents (e.g. Haskel and Westlake, 2017; IMF, 2019).

However, these superstar firms can abuse their initial advantages to further expand market dominance through strategies of a more organizational, institutional and political nature, based on anti-competitive product market regulation and weak antitrust enforcement (e.g. Furman and Orszag, 2018; Gutierrez and Philippon, 2017, 2018), with evidence suggesting an increase in the importance of abusive market power since about 2000 (Covarrubias et al., 2019).

Widely recognized mechanisms by which such abuse of market power affects market concentration include situations where incumbent firms manipulate variables under their control in order to deter the entry of new firms, for example, by a strategic use of patents and the protection of intellectual property rights; takeovers of small innovative firms to acquire cheaply their innovation or to eliminate a potential competitive threat; or predation of the public sector for public procurement or large-scale privatization. Put differently, increased market concentration exacerbates inequality and the perception that the benefits of globalization are captured from existing wealth – "profits without prosperity" – while creating little employment (*TDR 2017, 2018;* Cairo and Sim, 2020).[13]

Several features of the Covid-19 pandemic could well further increase the dominance of large firms. Consumption habits are likely to maintain the increased market shares of e-commerce and digital platforms even once social distancing measures will be abolished. And while digital technologies could benefit smaller companies through easier market access in a digital world, larger companies tend to be better positioned to use digital technologies most effectively (e.g. Bessen, 2017). The healthcare sector, where the role of large companies using intangible capital is particularly prominent (e.g. Crouzet and Eberly, 2019), is likely to increase its importance in production structures. Cash reserves of bigger companies are likely to exceed those of smaller firms that will find it more difficult to survive extended periods of low activities (Gryta and Francis, 2020). This greater vulnerability to bankruptcy could also cause smaller firm to seek integration into larger companies because antitrust authorities will look at vertical integration more favourably than at horizontal mergers between companies in the same sector.[14]

The extreme concentration of export markets is an additional mechanism through which market power can affect distributional outcomes and perceptions of an unfair sharing of the benefits of globalization. Firm-level data on non-oil merchandise exports show that the distribution of exports is highly skewed in favour of the largest firms, with the top 1-per cent of firms accounting for 57 per cent of country exports on average in 2014 (*TDR 2018*). The size of these firms and their ability to generate super-profits in export markets has diluted their accountability to national constituencies.

In both developed and developing countries, the perception that the benefits from globalization have been unfairly skewed to large conglomerates is reinforced by their ability to pay little or no tax on the rents they extract. Evidence on the exploitation of loopholes and tax havens or low-tax jurisdictions shows, for example, that companies from the United States generate more investment income from Luxembourg and Bermuda than from China and Germany (*TDR 2018*). This clearly reflects aggressive tax optimization by locating tax bases in low-tax jurisdictions (Contractor, 2016). Estimates of the volume of these tax-motivated illicit financial flows (IFFs) of international corporations vary widely. Recent findings vary from between $180 billion to $500 billion a year, depending on the methodologies used and the countries covered, with roughly one third of these amounts relating to losses of fiscal revenues in developing and transition economies (*TDR 2019;* Cobham, 2020).

The existing international corporate tax norms facilitate these profit-shifting practices as they leave decisions where to record profits to corporations themselves, regardless of where the profit-making activity takes place. This system dates from the 1920s and was designed at a time when most trade in manufactures concerned final goods and took place between separate firms. It is ill-equipped to deal with current characteristics of trade mostly concerning intermediate goods and, increasingly, services and taking place between subsidiaries of border-straddling companies.

A stark example of the primacy of financial over real-economy considerations is the observation that an increasing share of FDI – over a third of the total – passes through empty corporate shells rather than being invested in productive activities in the receiving economies (Damgaard et al., 2019). This type of FDI can be used for intra-company financing or to hold intellectual property and other assets. For tax-optimization purposes, it is concentrated in a few tax havens (e.g. Delatte et al., 2020), depriving many countries of a fair share in the benefits of globalization.

Moreover, intellectual property has itself become an increasingly important source of rent extraction, particularly from developing countries. Technological leadership has been a longstanding barrier to market entry, a source of super-profits for firms from advanced economies and a persistent challenge to firms from countries trying to catch-up. However, in recent years the widening and tightening of intellectual property laws, including in bilateral, regional and multilateral trade agreements, often under intense lobbying from large corporations, has become

increasingly disconnected from creative activity that boosts output and productivity and has instead turned knowledge and information into key strategic assets in the search for rents (*TDR 2017*).

3. The mutation of financial globalization

While the evolution of trade and FDI, combined with the shrinking of GVCs, suggests a nominal retreat from the unsustainable highs of globalization, financial globalization has, despite the GFC, continued to dominate the global economy, increasingly through a new generation of financial players in the so-called shadow banking sector (*TDR 2019*; Shaxson, 2018) and through the ever growing dependence of the non-financial corporate sector on debt-driven financial transactions as a source of income (chapter I).

The period since the early 1980s saw a deregulation of markets not only for traded goods but even more so for financial and currency markets. Capital-account liberalization proceeded rapidly and has remained high in developed countries. It has advanced less steadily in developing countries, where it was punctuated during the debt and financial crises of the 1980s and 1990s and reached a peak in 2007–2008, when the GFC triggered a moderate reversal of liberalization policies, including with a view to shielding domestic financial markets from a rapid accumulation of foreign-held financial assets that would be heavily exposed to sudden capital flows reversals. However, over the past decade, developing countries have witnessed a rapid and often premature integration into heavily underregulated international financial markets, including the shadow-banking sectors, estimated to be in control of around half of the world's financial assets (FSB, 2020).

Since that crisis, the total debt stocks of developing countries – external and domestic, private and public – has mushroomed reaching close to 200 per cent of their combined GDP, the highest level on record. The closer integration of developing countries into the international financial system has been accompanied by a sharp increase in both the level and volatility of net private capital flows to these countries. Capital flow volatility is particularly large in developing countries because they are exposed to global financial cycles – the co-movement in global and domestic financial condition across countries – to a considerably greater extent than developed countries. This can be observed also during the Covid-19 crisis (chapter I).

TABLE 5.2 **Share of cumulative total profits in the Forbes Global 2000, selected industrial sectors and countries, 2005–2017**
(Percentage)

			"Old economy"		
Autos/trucks		*Oils*		*Chemicals*	
China	6.6	China	10.2	China	0.6
Germany	30.7	Japan	0.9	Germany	18.6
Japan	34.5	Russian Federation	18.3	Japan	8.6
Republic of Korea	8.9	United Kindom	5.8	Netherlands	5.2
United States	4.7	United States	27.4	United States	26.9
Memo item: Sector share	3.6		12.0		2.7
		"New economy" - technology hardware and software, biotech and pharmaceuticals			
Bio-pharma		*Technology hardware*		*Technolgy software*	
Germany	2.0	China	0.4	China	7.2
Japan	5.8	Germany	0.6	Germany	5.3
Switzerland	18.1	Japan	4.0	India	8.1
United Kingdom	12.0	Republic of Korea	10.6	Japan	0.4
United States	48.3	United States	73.8	United States	70.5
Memo item: Sector share	4.3		7.2		2.7

Source: Schwartz (2019 table 3), based on Forbes Global 2000.
Note: Sector shares refer to shares in total profits of Forbes Global 2000.

New financial vulnerabilities have emerged from these trends that are likely to hold back growth. Emerging economies, in particular, have seen a rapid build-up of private debt in reserve currencies and increased penetration of their markets by non-resident investors, foreign banks, and other financial institutions, as well as allowing their own residents to invest more freely abroad. There has also been a strong shift in the ownership of central government debt, including public external debt, from official to private creditors and shadow-banking actors. These trends heighten developing countries' external vulnerabilities and entail large transfers of resources to advanced economies through various financial channels. As argued extensively in previous UNCTAD reports, even with the exceptionally low interest rates seen since the financial crisis, the resulting wave of debt accumulation was looking more and more fragile even before the coronavirus crisis hit. The greater presence of foreigners in bond and equity markets has, moreover, increased the potential instability of exchange rates and further exposed domestic financial markets to the vagaries of global risk appetite and liquidity conditions.

The developing country debt crisis, already under way prior to the Covid-19 shock, had many facets, but two are worth highlighting. First, it was not limited to the poorest of developing countries but affected developing economies of all income categories. Second, it has, by and large, not been caused by economic mismanagement at home, but by economic and financial mismanagement at the global level.

Although the haemorrhaging of capital from developing countries seen in March and April this year has come to a halt, it has left many of them in a very fragile state. Subsequent reversals, when investors measure their exposure against continued crisis conditions in the real economy, could tip many into financial chaos. Moreover, even if the calmer financial conditions of mid-2020 persist, the extra borrowing from developing countries adds to the record levels of outstanding debt that had prevailed prior to the pandemic (*TDR 2019*). Indebted countries remain at the mercy of out-of-control financial markets.

D. Reviving multilateralism

Recovering from the recession triggered by the Covid-19 crisis, addressing the deeper economic, social and financial stresses and fissures exposed by the crisis and averting environmental breakdown will require a new vision of an interdependent world. The original New Deal, and its international outgrowths, offered such a vision by widening the reach, expanding the powers and broadening the purpose of the public sector. Redefining the reach, powers and purpose of the State is certainly key to recovering better from the Covid-19 crisis.

Reviving multilateralism is not a matter of making incremental changes to existing rules and practices but involves a system-wide transformation that connects immediate relief efforts to mitigate the serious damage to lives and livelihoods from the pandemic and the associated countermeasures. A sustained recovery programme will involve massive job creation, a redistribution of income along both functional and household lines to new sources of growth that can provide the foundations of a more resilient development path that includes a dramatic lightening of our economic footprint on the planet. On a more normative level, this will mean (i) retreating from a damaging form of integration in a less costly way than was the case in the 1930s; (ii) promoting a collective vision that can help establish new rules, principles and policies in line with the Agenda 2030; (iii) building a more democratic (and less hegemonic) model of global governance.

1. An ambitious retreat

Boosting global aggregate demand will be crucial to avoiding upheaval. Without a significant and sustained increase in wages and government spending, the global economy will continue on a path of sluggish growth and distributional struggles with political polarization preventing efforts to establish a more resilient social contract. Ensuring countries have sufficient fiscal space to adopt recovery packages was discussed in the previous chapter including the need to adopt ambitious public investment programmes as a way to crowd in private investment helping to boost productivity growth, and at the same time expanding employment opportunities that help people to find jobs at improved wages in line with productivity growth and attenuate their adverse attitudes towards globalization and government action, as discussed in chapter III.

A resilient economy needs to be a caring economy and investment in health and related sectors must be a priority. That poses particular challenges for many developing countries who will require significant financial support from the international community (Box 5.2)

There is a certain irony in the fact that it took a microscopic pathogen to achieve reduced emissions and cleaner air. Moreover, there is mounting evidence that Covid-19 is itself linked to environmental destruction rooted in a propensity to cut and clear dense, wild forests and replace them with intensive livestock operations and driven by the same rent-seeking methods that have come to dominate corporate governance more widely (Wallace et al., 2018; UNEP, 2020). However, shutting down the economy is not a long-term strategy for crushing the pandemic or greening the global economy. Rather, experiences from many developed and developing countries demonstrate that reducing carbon emissions and maintaining development objectives can be combined only through boosting and directing public spending to meet environmental challenges (*TDR 2019*).

BOX 5.2 A global Marshall Plan for health recovery

The United Nations and the G20 have sketched out the elements needed to meet the immediate health emergency in the developing world but if the mission is, as it should be, to ensure resilience to future health shocks, relief cannot be separated from related policy challenges around sanitation, food security, precarious work and housing conditions. That poses an integrated challenge not unlike that addressed by United States Secretary of State George Marshall's plan for European recovery in 1947.

So what should a Marshall Plan for a global health recovery look like? First, talk of international solidarity must carry matching financial commitments. If the generosity of the United States, more than 70 years ago, is too high a target, it should not be too much to expect the donor community to finally meet the 0.7 per cent official development assistance (ODA) target for the next two years. Doing so would generate something in the order of $380 billion above current commitments. An additional $220 billion mobilized by the network of multilateral and regional financing institutions could complete a $600 billion support package over the next 18 to 20 months; this will require a boost to their capital base, made possible through transfers from the bank's shareholders, augmented by borrowing on international capital markets, with a measured relaxing of their AAA credit rating where appropriate.

Second, the money should be dispersed largely as grants but with some room for zero-interest loans, the precise mixture determined as the emergency response evolves. The looming developing country debt crisis will have to be dealt with through complementary actions, including an immediate standstill on debt payments followed by restructuring and cancellation.

Finally, given the multi-faceted nature of the recovery effort, a dedicated agency, drawing, like the Marshall Plan, on the personnel of existing agencies as well as from the private sector, with local expertise and coordination must be involved from the outset. Much like the original, a central financing and oversight agency linked to national public agencies through a regional coordination mechanism remains a model to follow.

Self-interest as well as genuine humanitarian considerations motivated the original Marshall Plan. That remains true today. With the virus already gripping much of the developing world, contagion will return to countries that had thought the epidemic was under control. Just as importantly, as the advanced countries move from relief to sustained recovery, ensuring the South plays its role in a repaired international division of labour and trading system will be critical, albeit on better terms than was the case before the crisis.

Ensuring that responses to the Covid-19 crisis include policy and investment decisions that address the climate emergency will require associated rules and norms to gain greater prominence in managing globalization. Embarking on a non-carbon-intensive growth path is technologically possible. And there is considerable scope for both developed and developing economies to gain from the opportunities that will emerge from a rapid structural shift to renewable sources of energy, climate-friendly technologies, low-carbon capital equipment, and more sustainable modes of consumption. But any measures adopted in this respect must ensure, from the very beginning, a fair sharing of both the efforts and the gains from this transformation. The main obligation rests on the main carbon emitters and, in particular, the advanced economies whose economic success has been built by exhausting most of the planet's carbon space. A fair and sustainable deal requires global cooperation and clear recognition of the very different positions — in terms of past behaviour, present responsibility and future needs — of countries. The commitment to common but differentiated responsibilities must be upheld, underpinned by robust multilateral principles and structures.

However, in today's world of mobile finance and porous economic borders, many countries will be reluctant to adopt a bold strategy to boost public investment, jobs and income on their own, out of fear that much of the benefit of rising demand would leak to other countries, or that it would cause capital flight and currency depreciations. What is needed, therefore, is more effective coordination of national policy efforts, with all countries being offered the opportunity of benefitting from a simultaneous boost to their domestic and external markets (*TDR 2019*). The macroeconomic stimulus package adopted by the G20 in 2009 demonstrated that such a strategy can succeed in spurring economic recovery. However, even before it was prematurely abandoned, there were growing concerns that this lacked the legitimacy required to ensure its long-term success. In this respect, linking the G20 process to deliberations at the United Nations in ECOSOC could offer a way forward (Stiglitz, 2009).

2. Enhancing the developmental role of the multilateral trading regime

The multilateral rules and structures that were created after the Second World War aimed at avoiding a repeat of the economic damage and international economic disintegration of the 1930s. These concentrated on preventing "beggar-thy-neighbour" policies, restraining volatile capital flows and extending international cooperation with a view to ensuring strong aggregate demand and facilitating a rapid rise in international trade whilst maintaining enough space for national governments to pursue their growth and development objectives. The rules it should be recalled, provided continued protection to import-sensitive sectors in advanced economies while seeking open markets in sectors where their exporters were strongest.

The multilateral rules-based trading regime that emerged from the Uruguay Round of negotiations and governed by the WTO can benefit developing countries to the extent that it attenuates the pressure that powerful countries can bring to bear on trade negotiations and relations, allows protection and support in sensitive sectors and infant industries, and opens export markets in sectors where they are competitive. However, in practice, the scope and content of the rules, the ability to take advantage of differentiation in their favour, to make use of grey areas in rules (or indeed, to deviate from them as has happened during the pandemic), the topics chosen for negotiation and the implementation patterns of agreed outcomes have, for the majority of developing countries, not been conducive to economic catch-up (Davis, 2019).

The extension of rules that open financial markets and lock-in footloose capital has not been matched by market opening for labour or transfers of intellectual property. The Uruguay Round agreements 25 years ago extended the scope of multilateral disciplines to include rules that severely limit the scope of domestic development and industrial policies through very deep tariff cuts, Trade Related Investment Measures (TRIMS) limiting localization measures and Trade Related Intellectual Property Measures (TRIPS) restricting "adaptive innovation" of the sort that had been central to East Asia's industrialization. Advanced economies have successfully established a multilateral order that diminishes space for promoting industries, mainly in developing countries, that are critical to climbing up the development ladder, while increasing scope for sponsoring the technology-intensive sectors now critical to securing national prosperity in advanced economies (*TDR 2016*).

Negotiations launched in Doha in 2001, officially the Doha *Development* Agenda, represented an attempt to rebalance the trading system in important respects, but over the course of negotiations there have been attempts to shift away from that objective. The demands for new market opening in developing countries increased alongside a moderation in the commitment to address the core developmental concerns of many developing countries, particularly in agriculture. With the Doha round having reached an impasse, the developmental mandate has been frustrated. More advanced and industrial economies have turned to bilateral and regional trade agreements that extend and consolidate GVCs in which they lead. Combined with the growing tendency for plurilateral negotiations risks fragmenting the trading system and eroding its multilateral character. Finally, this fracturing of the multilateral trading regime has been exacerbated by the heightened tensions between the United States and China.

Overly burdensome trade rules can pose a serious threat to equitable access to vaccines or health equipment as well as recovery programmes. A "Peace Clause" on Covid-19 related WTO and investment protection cases would enable countries to quickly adopt and use emergency measures to overcome intellectual property, data, and informational barriers to Covid-19 related health measures, with a permanent standstill in all relevant fora on claims on government measures implemented in the context of Covid-19 creating the necessary policy space to support recovery efforts. An immediate moratorium on investor-state dispute settlement cases by foreign corporations against governments using international treaties, and a permanent restriction on all Covid-19 related claims, would also help.

Moreover, delivering on the core issues of the developmental mandate of the Doha negotiations would be a way to restore trust in the trading system with a commitment to special and differential treatment as a prerequisite for ensuring a fair outcome.[15] As part of restoring trust, new issues, such as digital rules, should not be multilateralized until developing countries understand their development dimensions and accordingly build their digital competitiveness. An independent commission could be established to examine whether and to what extent, over its 25 years, the actions of the WTO have lived up to the

promise of Marrakesh, the agreement that finalized the Uruguay Round.[16]

The world needs a new framework, perhaps in the context of WTO reform, that seeks accommodation with the two largest trading nations but also broadens the space for development policy. It can advance proposals that progressively widen spaces for development by harnessing a virtuous cycle of increased productive investment, fair and balanced trade, and innovation-sharing for global economic growth from which all can derive benefit. In more general terms, it would imply seeing the multilateral trading regime as a mechanism by which trade globalization and the nation State are not competitors but are mutually reinforcing. Doing so will, however, require a more integrated approach to the different components of the multilateral architecture (*TDR 2014*).

3. Tackling corporate rent-seeking

Increase in market concentration, proliferation of anti-competitive practices, abuse of dominant market position, and corporate tax avoidance and evasion have become ubiquitous features of today's rentier economy, made possible by deregulations and absence of appropriate state actions. This has become widespread in both financial and non-financial sectors but has so far reached a pinnacle in the digital economy by platform monopolies that have further strengthened their positions since Covid-19.[17] Accordingly, the power of corporations to influence and rig the rules of the game, not only on the national, but also on the international level, has increased relentlessly.

To curtail market monopolization and corporate rent-seeking, much of the regulatory structure dismantled over the past four decades needs to be restored. In addition, antitrust and anti-monopoly laws have to be updated to account for newer developments and specific challenges of our time such as network effects in the digital economy. Such restoration could start with The Set of Multilaterally Agreed Equitable Principles and Rules for the Control of Restrictive Business Practices adopted by the United Nations General Assembly in 1980. It could also take into account the more recent efforts of European Union regulators to curb the dominant positions of certain digital platforms.

Additional action regarding patents and the protection of intellectual property rights would be necessary to prevent their abuse for anti-competitive practices. Stricter enforcement of existing national disclosure and reporting requirements for large corporations, such as through a global competition observatory, could facilitate the task of systematic information gathering on the large variety of existing regulatory frameworks, as a first step towards coordinated international best practice guidelines and policies, and to monitor global market concentration trends and patterns. The pharmaceutical sector is a good place to start, given the public health crisis caused by Covid-19.

As discussed in chapter IV, the Covid-19 pandemic brought into sharp focus what government expenditures would have been possible and how many lives been saved, had the international community advanced further in tackling IFFs in general and tax-motivated IFFs in particular, including the closing of tax havens, beginning with those in the advanced countries (Shaxson, 2018). Regrettably, multilateral efforts towards reforming international corporate taxation under the OECD Base Erosion and Profit Shifting (BEPS) initiative, insufficient as they were, have suffered a setback by the recent withdrawal of the United States and are unlikely to lead to meaningful reform in the near future.

However, there is a strong case to be made for broader reform of international corporate taxation that deals with profit shifting and addresses the global inequalities in taxing rights between countries under the auspices of the United Nations as a genuine global forum (*TDR 2015, 2019*). To prepare such genuinely global multilateral rule making, discussion groups could be formed to explore options and their consequences and to further consensus building. Such discussion could receive technical and logistical support from the G-24 (Cobham, 2020) or through UNCTAD intergovernmental pillar.

Such talks should aim at unitary taxation that recognizes that the profits of global corporations are generated collectively at the group level, combined with a global minimum effective tax rate on all profits, and the distribution of ensuing revenues governed by formulary apportionment, whereby the total taxes of a corporate group are allocated across countries according to an agreed formula, ideally one that prioritizes employment and productive physical assets over total sales, as discussed in chapter IV.

In addition, the digital economy has already created significant new regulatory challenges. The network effects and economies of scale in digital economy

often result in creation of super-platforms which can abuse their dominant position with a wide range of anti-competitive policies. Closely related, but separate, is the problem of control and use of private data collected by super-platforms. This has already spilled over into electoral issues in several developed countries. Tackling these issues will not be possible solely with national legislation, but rather with a concerted international action.

Finally, the issue of taxation of digital super-platforms is crucial, especially for developing countries. The ideal solution would be to introduce taxes on digital services, which would make digital enterprises pay their taxes to jurisdictions where their customers are located. However, this will have to be a coordinated international effort since super-platforms operate globally and national legislation cannot deal adequately with these issues. One promising way would be to base international tax norms on "significant economic presence" and adopt a global effective minimum tax rate on an MNE global profits, as discussed in chapter IV.

4. Domesticating finance

Only with a system-wide transformation of finance can we meet the immediate relief needs of Covid-19 and recover better. Both goals depend on increasing the scale of finance available, guiding it to where needed, and increasing its effectiveness – three things that can only happen if capital is domesticated sufficiently that it returns to its role as servant not master of the real economy.

As argued in previous *TDRs* (including 2018 and 2019), we need a re-regulation of finance. This includes tackling the giant private banks through international oversight and regulation; addressing the highly concentrated and critical market for credit rating; and the cosy relationship between rating agencies and shadow banking institutions. At the same time, public banks should be strengthened; Covid-19 should serve as a reminder that the current model of private finance does not provide long-term lending, for activities that are truly transformative, and to countries where needs are greatest.

These issues were on the radar screen for most governments long before Covid-19 but are now laid bare after months of systemic shock and dislocation. There has been no lack of money, but rather a lack of money going to where it is needed. Covid-19 also showed that some policy measures which had always seemed either impossible, or very far distant, could, when push came to shove, be put into place quickly. The challenge ahead therefore is to keep this momentum and to ensure that immediate policy responses are coherent with longer-term ones. And intervention must be global. Although most Covid-19 policy levers have been national, only global co-ordination can flatten the curve of both Covid-19 and its concomitant macroeconomic pain.

More immediate reforms that can help include the following, starting at the national and expanding to regional and global level:

Cooperation among central banks is more important than ever. This has already been happening and on a wider set of issues than was the case after the GFC, and it includes important elements relating to the creation of a greener financial system. But deliberations are rather technical and somewhat opaque. It is time to debate more explicitly the trade-offs and assumptions being made and their global implications. For example, quantitative easing (QE) and lower interest rates in many countries certainly scaled up liquidity quickly but needs to be reviewed to ensure they benefit households and SMEs and not just wealthy individuals and cash-rich firms.

Also, not all countries can use QE without risking balance of payments crises; and central bank swap lines from reserve currency central banks have been extended to only a handful of developing countries. Advanced countries need to explore ways to collaborate more globally or at least regionally, to create and share the benefit of these policies with more developing ones. Such collaboration could be reflected in regional financial agreements, such as the Chiang Mai Initiative, or by creating a network of swap lines in the IMF, which could be funded by an allocation of SDRs and countries not using their allocations making the funds available to the IMF (e.g. Gallagher et al., 2020).

Support for national and regional development banks would scale up their available capital and allow them to use it more effectively. These are the financial institutions that will do the heavy lifting, being mandated to offer the kinds of long-term maturities, with concessional or favourable conditions. Governments in advanced countries could join membership of banks in lower income ones, increasing their capital base and making it easier for them to access international capital markets. Most banks in most countries moreover are constrained in both the scale of their

lending and the kinds of projects they can lend to, by government shareholders' insistence they maintain permanent AAA credit ratings. If, however, government owners sent convincing signals of their support for the banks they own and for their developmental mandate, lending could increase significantly, and more socially beneficial projects could begin. Some banks have been too cautious: evidence suggests that major public banks could increase lending by at least $1 trillion without losing ratings, so the blame cannot be laid entirely on rating agencies (*TDR 2019*).

Other sources of finance that could be aligned to public banking include *sovereign wealth funds*, which are nationally owned public assets, holding at least $8 trillion and seldom directed towards developmental, green investments or regional investments. Coronavirus was a shock to the world's sovereign wealth funds, impacting their source of funding (often oil) as well as jolting geopolitical structures (SWF Institute, 2020) but they could still potentially contribute to increasing scale, and if mandates were revisited could guide it to more effective uses as well. Another public source of finance mooted in recent months concerns *perpetual bonds*, which can take advantage of today's low interest rate environment and could even harness the demand for green and ethical investment vehicles as well. Used by the Dutch four centuries ago to finance building and maintenance of dykes and waterways, they involve annual interest fees, but the principle is never repaid. They are interesting to investors in current conditions, when some countries are issuing 30-year bonds with negative yield and some cash-rich firms or households are paying a fee to park their funds. It is estimated that an interest of 0.5 per cent could enable a government-backed perpetual bond to raise $1 trillion at a cost of $5 billion per annum, which would suit long-term investors such as life insurance companies who need long-duration assets to match their liabilities.

These measures for scaling up finance at domestic or regional need also to go hand in hand with more effective *international regulation*. Volatile international capital flows generate financial cycles that increase fragility in receiving countries, especially developing ones. These countries need multiple instruments to integrate effectively into the global economy, without preconditions for their use. These should combine macroeconomic policies that secure economic growth; prudential policies, comprehensive and lasting capital controls, and other regulatory measures that insulate domestic conditions from externally generated destabilizing pressures. These will need to be country-specific, determined by the nature and degree of a country's financial openness and by the institutional set-up of its financial system, and should be kept out of the purview of regional and bilateral trade and investment agreements. Capital controls will moreover be most effective when managed at both ends, i.e. in both sending and receiving countries (*TDR 2019*).

UNCTAD has also long argued that a different kind of *credit rating agency* (CRA) is required, or that existing CRAs play a different role (e.g. *TDR 2015*). One problem is that ratings agencies, like banks, act in a pro-cyclical manner that not only limits the catalytic potential of SWFs and public banks, but also accentuates broader financial sector vulnerabilities. Another is that the world's largest CRAs are also among the companies that profited during the most intense months of the crisis – as central banks and governments' attempts to boost liquidity prompted a cascade of newly rated issuances. It is not appropriate that CRAs should continue to hold this *de facto* role of arbiters of responsible financial behaviour – especially when they are also players in the same market they regulate.

Both the *IMF and the World Bank* increased their support for nations in difficulties following Covid-19 but have not addressed any of the longstanding concerns of developing countries for the orientation of these multilateral finance institutions nor their governance. Support still comes with strings attached that expand the remit of the market at the expense of the public sector and insist on austerity even during times of downturn, the gutting of public administration and public services even at a time of health emergency, the privatization of state-owned enterprises and natural resources and the removal of regulations of labour markets and other economic activities. These self-defeating conditions have been a source of complaint for many countries since the 1980s but were nonetheless reiterated in the Covid-19 packages.[18]

The "Maximizing Finance for Development" approach to lending which has structured its operations since 2017 has not attracted the trillions of dollars managed by private institutional investors it envisaged; and moreover, funds that were harnessed have rested on governments sweetening the deal, intervening to smooth the way for private finance and using guarantees and public-private partnerships (PPPs) that leave too much of the risk in the hands of government and not enough of the profits. *PPPs*

are not the answer (*TDR 2018*; Romero, 2020), as these too often have been accompanied with large, unanticipated costs for governments even during benign times. In the post-Covid-19 environment, governments that guaranteed minimum revenues to their private sector partners in PPPs may find contingent costs run into the hundreds of millions of dollars, for services not used because of economic downturn. The bill for these unexpected shortfalls in revenue must not land onto governments in developing countries.

Finally, action is needed to rebalance governance of these historical institutions. This could include ending the implicit agreement that the IMF is managed by a European and the World Bank president chosen by the United States (Kentikelenis, 2020), and reforming voting arrangements to reflect economic size and principles of equity. Large and growing developing economies need voting weight commensurate with their size.

5. Promoting a global debt deal for development

A restructured multilateral system would be incomplete without a fit-for-purpose sovereign debt architecture. Despite the central role played by sovereign debt distress in the economic chaos of the inter-war years, the 1944 Bretton Woods Agreement excluded this piece of the puzzle. While sovereign debt crises were rare until the advent of financial globalization in the 1980s, this has subsequently proved a costly omission and failure to fill this gap could herald another lost decade for the developing world post Covid-19.

The ad hoc architecture that has evolved to deal with debt crises in the hyperglobalized era (*TDR 2015*: chapter VI) has strongly favoured creditors and is inadequate to deal with increasingly chronic financial vulnerabilities across developing countries and a debt landscape that has grown massively in scale and complexity (*TDR 2019*; chapter IV). The faltering efforts by the international community to provide adequate and timely debt relief in the wake of the Covid-19 crisis are only the latest manifestation of gaps and shortcomings that have long been known. These include the "too little, too late" characteristic of past debt restructurings, debt crisis resolutions that strongly favour procyclical austerity policies undermining future growth perspectives and debt sustainability, recurrent crises (Guzman, 2019), and the growing fragmentation of mechanisms to address different creditor interests, evident in the problems posed by hold-out creditors (UNCTAD, 2020b).

With bond finance of long-term public and publicly guaranteed external debt of developing countries increasing rapidly since the GFC, by now accounting for around half of this debt (*TDR 2019*), improved bond contracts have become even more relevant. A core initiative, requiring multilateral coordination by lead central banks and multilateral development banks, is to raise the profile and facilitate the use of state-contingent debt instruments (SCDIs) in international financial markets. SCDIs are private financing instruments that resemble equity in that they represent a longer-term stake in a country's developmental performance by linking returns to private investors to underlying macroeconomic and developmental variables, such as GDP growth, commodity price trends, export performance or the occurrence of natural disasters, including pandemics. While the design of SCDIs has progressed (Barr et al., 2014), their uptake by private creditors in international financial markets has been less than lukewarm, not least for lack of coordinated leadership from existing authorities.

But the challenges go beyond reconciling bondholder interests with longer-term developmental needs through the backing of relevant financing instruments. Once a sovereign debt crisis hits, the current maze of negotiating procedures, whether bilateral or multilateral, and lacking basic coherence and transparency, will impede swift resolution of the problem. Influential private creditor groups can thus leverage their bargaining and hold-out powers, often at the expense of an equitable and sustainable crisis resolution for the debtor sovereign and its citizens, as well as the longer-term collective interests of private creditors. Even in a large developing country, such as Argentina, recent restructuring negotiations with private creditors were set to fail in the face of the intransigence of few, but powerful, creditor groups, until the government threatened to halt talks and prioritize a deal with its largest multilateral creditor, the IMF. This credible threat brought private creditors back to the negotiating table and resulted in an eventual compromise solution (Smith and Mander, 2020). But this option is closed to most developing countries, not least since the IMF exposure to these countries tends to be much smaller.

For this reason, proposals for a comprehensive and transparent framework for orderly, balanced and fair sovereign debt workout mechanisms have been advanced for many years, including Krueger (2002),

TDR 1986 and UNCTAD (2015). So far, these have fallen on deaf ears, primarily in capitals beholden to the interests of their financial industries and centres. However, under the impact of the Covid-19 pandemic a willingness to reconsider and to support at least initial steps towards an improved international sovereign crisis resolution architecture might be greater than has been the case so far, and certainly should be. One such initial step could be the establishment of a global debt authority or standing body (UNCTAD 2020, forthcoming). Such an expert-based authority would be independent of creditor as well as debtor interests, while taking systematic account of all stakeholder concerns. Its remit could include the following tasks, in particular:

- Building a repository of institutional memory on sovereign debt restructurings and workout mechanisms;
- Overseeing the establishment of a global publicly accessible registry of loan and debt data pertaining to sovereign debt restructurings. This registry could be hosted by the global debt authority in the longer run or another host organization could be designated;
- Expending independent technical advice and assistance on sovereign debt restructurings to developing country governments at their request;
- Developing a blueprint for a comprehensive and transparent international legal and institutional framework to govern sovereign debt workout mechanisms in future;
- Developing a blueprint for institutional and legal procedure to enable comprehensive and automatic temporary standstills on debt repayments (or debt moratoria) in the event of a disaster, including appropriate definitions of what constitutes a disaster;
- Providing a model national law to address litigation by hold-out creditors (often called "vulture funds"), including through the incorporation of existing international soft law principles into national legislation; and
- Establishing arbitration tribunals under its auspices to address debtor-creditor as well as inter-creditor conflicts in ongoing sovereign debt restructurings.

UNCTAD intergovernmental mechanism could offer a possible venue to further explore and elaborate the details of any such authority.

Notes

1 *Financial Times* (2020). Emmanuel Macron interview. 17 April.
2 *Financial Times* (2020). Virus lays bare the frailty of the social contract. 4 April.
3 Macfadyen et al., 2019; Pedersen, 2015.
4 The task of "returning to normalcy" resided with the League's Financial Committee which was "largely run by bankers and Treasury officials (and) was effectively entrusted by the British government and the Bank of England with the task of restoring monetary stability to east-central Europe, setting up new central banks, advising governments on budgetary discipline, and in return underwriting access to west European capital markets", Mazower, 2013:150-151.
5 Polanyi, 1944: 27, described the tenacious desire of the post-war establishment to return to the gold standard as "the invisible reality to which the will to live could cling, when mankind braced itself to the task of restoring its crumbling existence".
6 The classic account of the United States as a reluctant hegemon, able but not willing to orchestrate international financial stability after World War One, is provided by Kindleberger, 1973. See also Tooze, 2014; Eichengreen, 1996; Boyce, 2009.
7 Though sometimes forgotten, Bretton Woods hosted the United Nations Monetary and Financial Conference.
8 On the history and working of these offshore markets see He and McCauley, 2010; Norfield, 2016.
9 For a recent account on the links between globalization and inequality, see Huh and Park, 2020.
10 For an early warning that rising inequality may cause a pushback of globalization to start in developed countries, see UNCTAD, 1997; see also Autor et al., 2013; and Rodrik, 2020.
11 For detailed discussion of this issue, see Akyüz, 2017.
12 See, e.g., Richard Waters (2020). "Big Tech is emerging from the crisis stronger than ever", *Financial Times*, 22 May.

13 While these mechanisms largely relate to increased market power causing higher profit and lower wage shares, market power can affect inequality also through price effects. Assuming market power to be used to impose higher prices on consumers, Ennis et al. (2019: 519) argue that the "wealthy, while paying more for goods, will at the same time receive higher profits from market power, due to their generally higher ownership of the stream of corporate profits and capital gains. The increased margins charged to customers as a result of market power will disproportionately harm the poor, who will pay more for goods without receiving a counter-balancing share of increased profits […] with the middle class being the group of the population affected most."

14 Some of these issues are further discussed in PR Orzag (2020). "The pandemic will make big companies more dominant than ever". *Bloomberg*. 27 April. Available at: https://www.bloomberg.com/opinion/articles/2020-04-27/covid-19-will-make-big-companies-more-dominant-than-ever.

15 Despite negotiations being conducted since 2013 in a more flexible and pragmatic fashion focusing on some key issues, including TFA, food security and agricultural export subsidies, there was still no consensus on the Doha mandate at MC10 in Nairobi in late 2015.

16 Namely, from the preamble to the Marakesh Agreement, "trade and economic endeavour should be conducted with a view to raising standards of living, ensuring full employment and a large and steadily growing volume of real income and effective demand, and expanding the production of and trade in goods and services, while allowing for the optimal use of the world's resources in accordance with the objective of sustainable development, seeking both to protect and preserve the environment and to enhance the means for doing so in a manner consistent with their respective needs and concerns at different levels of economic development."

17 In mid-August 2020, Apple became the first company with market capitalization above $2 trillion. Additionally, the company went from $1 trillion to $2 trillion in less than half a year, and in the midst of the biggest economic slump since the Great Depression.

18 https://www.worldbank.org/en/news/speech/2020/03/23/remarks-by-world-bank-group-president-david-malpass-on-g20-finance-ministers-conference-call-on-covid-19.

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